THE TECHNIQUE AND PRINCIPLES OF AUDITING

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BY

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AND

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PREFACE

SOME years ago Mr. Pixley asked Mr. Binnie to collaborate with him in producing a further edition of his well-known work on the duties of auditors, written largely from the legal standpoint of a Chartered Accountant who was also a Barrister-at-Law. Mr. Pixley's lamented death brought this collaboration to an end. The present writers have prepared a treatise on the subject which is dedicated to his memory. With the consent of Mr. Pixley's Executors, they have incorporated part of his valuable work but have developed the more technical side of auditing as adopted nowadays by the expert auditor. Gee & Co. (Publishers) Ltd. have kindly allowed the writers to make use of Mr. Binnie's book, *Audit Programme and Procedure*, written many years ago for the Accountant Student's Library, and *The Accountant* has allowed the reproduction of the Table of Wear and Tear Allowances which it published in September last.

As the ability to balance a set of books in an expert way is a vital part in the equipment of an accountant, a special chapter has been introduced under the heading of "Method in the Balancing of Books."

A. D. BINNIE
BRIAN MANNING

October, 1937

It is with deep regret that I refer to the sudden death, in his turn, of Mr. Binnie not long after the writing of the above preface. Ironically enough, he wrote to me some months ago, when he was examining the proofs, expressing doubt as to whether his physique would outlast the technique, though he can have had little idea then that he would not live to see the publication of the book. He will be greatly mourned.

BRIAN MANNING

CONTENTS

TABLE OF CASES

TABLE OF ABBREVIATIONS OF PRINCIPAL REPORTS CITED

Acct.	Accountant Newspaper	1874–Current
Acct.L.R.	Accountant Law Reports	1874–Current
B. & Ad.	Barnewall and Adolphus, King's Bench	1830–34
Beav.	Beavan	1838–66
C.B.N.S.	Common Bench Reports, New Series	1856–65
Cab. & El.	Cababé and Ellis, Queen's Bench	1882–85
De G. & J.	De Gex and Jones	1857–59
E. & E.	Ellis and Ellis	1858–61
Exch.	Exchequer Reports (Welsby, Hurlstone & Gordon)	1847–56
F. & F.	Foster and Finlason	1856–67
H.L.C.	Clark's Reports, House of Lords	1847–66
Ir. R. [Preceded by date]	Irish Law Reports	1878–Current
J.P.	Justice of the Peace	1837–Current
Jac. & W.	Jacob and Walker	1819–21
L.J.C.C.	Law Journal, County Courts Reporter	1912–Current
L.J.Ch.	Law Journal, Chancery	1831–Current
L.J.K.B. or Q.B.	Law Journal, King's Bench Division or Queen's Bench Division	1831–Current
L.R.Ir.	Law Reports, Ireland, Chancery and Common Law	1877–93
L.T.	Law Times Reports	1859–Current
L.T.Jo.	Law Times Newspaper	1843–Current
L.T.O.S.	Law Times Reports, Old Series	1843–60
M. & S.	Maule and Selwyn	1813–17
M. & W.	Meeson and Welsby Reports, Exchequer	1836–47
Manson	Manson's Bankruptcy and Company Cases	1893–1914
Q.B.	Queen's Bench Reports, Adolphus and Ellis, New Series	1841–52
R. (Ct. of Sess.)	Rettie, Court of Session Cases (Scotland)	1873–98
R.R.	Revised Reports	
S.L.T.	Scots Law Times	1893–Current
T.L.R.	Times Law Reports	1884–Current
Taunt.	Taunton	1807–19
V. & B.	Vesey and Beames	1812–14
Ves.	Vesey Junior	1789–1817
W.N. [Preceded by date]	Weekly Notes	1866–Current
W.W.R. [Preceded by date]	Western Weekly Reports (Canada)	
Y. & C. Ch. Cas.	Younge and Collyer's Chancery Cases	1841–43

LAW REPORTS

L.R.C.P.	Common Pleas	1865–75
L.R.Eq.	Equity	1865–75
L.R.Q.B.	Queen's Bench	1865–75
L.R.H.L.	House of Lords	1865–75
Ch. App.	Chancery Appeals	1865–75
Q.B.D.	Queen's Bench Division	1876–90
Ch.D.	Chancery Division	1876–90
App. Cas.	House of Lords	1876–90
A.C. [Preceded by date]	House of Lords	1891–Current
Ch. [Preceded by date]	Chancery Division	1891–Current
P. [Preceded by date]	Probate Division	1891–Current
Q.B. or K.B. [Preceded by date]	Queen's Bench Division or King's Bench Division	1891–Current

THE TECHNIQUE AND PRINCIPLES OF AUDITING

CHAPTER I

INTRODUCTORY AND HISTORICAL

THE office of Auditor is one of high antiquity, and the date of its origin is difficult, if not impossible, to ascertain. It has certainly existed for six centuries, as in 1299 there is mention of an Auditor of the Accounts of the Corporation of the City of London. On the 24th March, 1324, Master John de Pykesleye and two others were appointed "to demand, audit, and take all accounts of those who are or will be held to render them in the counties of Oxford, Berks, Southampton, Wilts, Somersetshire, and Dorset; and to do and determine all things which the King's Auditors of accounts should do." In Langland's *Vision of Piers Plowman*, published in 1377, we find the following line, "Of my reue to take Al that myne auditour, or elles my stuwarde Conseilleth me by her acounte"; and in Paston's *Letters*, 631, II, 388, in 1469, "Send downe . . . to some awdyter, to take acomptys of Dawbney's byllys." In 1557, *Ord. Hospitalls*, B. IV, b, occurs, "There shall also be chosen Auditors generall of the Accomptys." Shakespeare, in *Timon of Athens*, puts into the mouth of Flavius the steward—

> If you suspect my husbandry, or falsehood,
> Call me before the exactest Auditors,
> And set me on the proof.

The first record of Auditors in Dublin is in the year 1452, and it would seem that the powers of the Auditor in those days even exceeded those of the Local Government Auditors of the present time. The surcharge of these Auditors has to be sued for in the ordinary way; while we read that in 1599, upon the Auditors of Dublin reporting two citizens (videlicet Master Nicholas Umfrey and Master Michael Pentney) to be indebted to the city in the sum of six score eight pounds, eleven shillings, seven pence CXXVIIJ^{l} XJ^{s} VIJ^{d}), it was ordered "by the authority of this post assembly . . . if they do not deliver the said silver pawns accordingly that then the said Master Umfrey and Master Pentney shall yield their bodies to the gaol of Tholsell within this city, and there shall remain to time they do pay and satisfy the said sum of six score

eight pounds, eleven shillings, seven pence, or deliver into the Treasury of this city sufficient silver pawns for the same sum."

THIRTEENTH CENTURY VIEWS ON AUDITORS

In Sir Walter of Henley's *Tretyce off Housbandry*, a manuscript of the thirteenth century, which has been printed by the Royal Historical Society, occurs the following sentence in the chapter "The Office of Seneschal"—

> The Auditors ought to be faithful and prudent, knowing their business, and all the points and articles of the account in rents, in outlays, and in returns of the garage and stock and other things belonging thereto. And the accounts ought to be heard at each manor, and then one can know the profit and loss. . . . The Seneschal ought to be joined with the Auditors, not as head or companion of the account, but as subordinate, for he must answer to the Auditors on the account for his doings, and for his commandments and approvements done by him on the manors. . . . It is not necessary so to speak to the Auditors about making audit, because of their office, for they ought to be so prudent, and so faithful, and so knowing in their business, that they have no need of other teaching about things connected with the account.

In July, 1645, Archibald Sydserfe presented a petition to the Scottish Parliament, which is referred to as follows in the Acts of the Parliament of Scotland: "Archibald Sydserfe humblie desyred the Estates of parliament That they would appoynt some auditoures for heiring and Fitting of his accomptes of these moneyes received by him for the publicts wse W[th] the Estates of parliament takeing to their consideratione Findes it fitting that the committie for the moneyes shall appoynt the saides Auditors."

ETYMOLOGY

Notwithstanding the fact that the word "Auditor" is always pronounced with the "i" short, there can be no doubt that it is derived from the Latin "Auditor," the ancient practice being for the parties whose accounts were to be audited to attend before the Auditor and vouch them orally, an example of which is given in the paragraph just quoted, the "accounts ought to be *heard* at each manor."

AUDITORS OF THE CROWN

Prior to Queen Elizabeth's reign, the accounts of the Crown were examined by auditors specially constituted for the purpose, or by the Auditors of the Land Revenue; or at times by the Auditor of the Exchequer, which office, the most ancient of all offices of control, was established in 1314, and continued until 1834, when it was abolished, and a new Department created, termed the Exchequer Office, or the Office of Comptroller-General of the Exchequer.

AUDITORS OF THE IMPRESTS

In 1559, the second year of the reign of Queen Elizabeth, two Auditors of the Imprests were first appointed. They continued in existence until the year 1785, when they were abolished, and their revised duties were taken up by the Office for auditing the Public Accounts. The Auditors of the Imprests were paid by fees chargeable on the accounts they examined. These were at established rates, but were sometimes increased by the Lord High Treasurer, on a memorial from the Auditors that the accounts were more voluminous than they had formerly been, or by a voluntary grant from the Lord High Treasurer, "for the pains" which the Auditors had been at in making up particular accounts.

NAVAL ACCOUNTS

The Accounts of the Treasurer of the Navy appear to have occasioned the first memorial from the Auditors for an increased allowance; this was in 1630. The two Auditors of the Imprests, as originally appointed, had no power to call upon parties to render accounts, but were dependent on the Treasury for obtaining them.

In 1649 the Auditors were empowered by the Committee of Public Revenue, sitting at Westminster, to call before them all such persons as had received any moneys upon Imprest or otherwise, to pass their accounts according to the usual course of the Exchequer. The same Committee abolished fees, and the two Auditors were allowed a fixed salary of £500 a year each "for themselves and their clerks, including all charges for house rent, pens, ink, paper, parchment, and all other incident expenses."

AUDITORS UNDER CHARLES II

With the Restoration of Charles II, the two Auditors returned to the former system of payment by fees and dependence on the Treasury, a practice which remained in force till the abolition of their duties in 1785. In 1783, owing to the increase in the Accounts, the Principals each obtained upwards of £16,000. The retired allowance to each Auditor on the abolition of the office was £7000 a year. Each Auditor had his Deputy and staff of six or seven clerks.

As an example of the scale of remuneration to the Auditors of the Imprests, the Account of the Chief Cashier of the Bank of England may be quoted, for the Audit of which £100 was allowed for every million of Capital Stock managed by that Company. The fees paid for auditing the Bank Account for the year 1784 exceeded £20,000.

FIRST AUDIT INDEPENDENT OF GOVERNMENT

The first attempt by the House of Commons to establish a control over the grants of Parliament, and to check the appropriation of supplies, was made in 1667, when it was determined by the House that the money voted for the Dutch War should be *applied only to the purposes of the War.* Commissioners for this purpose were appointed by "An Act for taking the Accompts"; and this may be considered as the first establishment of a Parliamentary Audit, or, in other words, of an Audit to a certain extent independent of the Government.

In 1785, on the abolition of the office of Auditors of the Imprests, its revised duties were taken up by the Office for Auditing Public Accounts. Various other officials for the auditing of the Accounts of Government Departments were from time to time appointed.

The first step was taken towards the establishment of a system of Account, based upon more practical principles, on the occasion of the revision of the Naval accounts in 1832, when the books in which the details of the Naval expenditure are recorded were recast on a connected plan on the principle of Double Entry.

PUBLIC ACCOUNTANTS

From a Treasury Minute, dated 16th June, 1848, it appears there were about 350 Public Accountants rendering Accounts to the Commissioners of Audit, and the Treasury complained of the delay in many cases, in presenting these Accounts. The following sentence is worth recording, as being applicable to all audits—

> My Lords do not understand on what grounds so much delay can have occurred in rendering these Accounts, it being the first duty of an Accountant to submit for audit, in a regular and punctual manner, his Account of the expenditure of the public money entrusted to him; and if this rule is not strictly enforced, the great advantage of an audit is lost, and it becomes impossible to exercise by means of it an effectual check over the public expenditure.

EXCHEQUER AND AUDIT DEPARTMENT CREATED

The Exchequer and Audit Departments Act, 1866, which received the Royal Assent on the 28th June, 1866, consolidated the previously independent Offices of the Comptroller-General of the Exchequer and of the Commissioners of Audit, and placed them under an Office, entitled the "Comptroller-General of the Receipt and Issue of Her Majesty's Exchequer and Auditor-General of Public Accounts" (29 & 30 Vict., cap. 39).

The Comptroller and Auditor-General is the guardian of the public purse, and in the exercise of this control his functions are broadly dual—

1. As Comptroller of the Exchequer it is his duty to see that all public moneys payable to the Exchequer are duly received and accounted for. On the other hand, no issues of money from the Exchequer can be made without his order, which is granted to the Treasury for the supplies voted by the House of Commons.

2. As Auditor-General it is his duty, as succinctly defined by the Exchequer and Audit Departments Act, "to ascertain, first, whether the payments which the Accounting Department has charged to the grant are supported by vouchers or proofs of payment, and, second, whether the money expended has been applied to the purpose or purposes for which such grant was intended to provide."

A general supervision is reserved to the Treasury, which has the power to require the Comptroller and Auditor-General to ascertain that the expenditure has been supported by their authority, and to report to them any expenditure which has been incurred without such authority. The right to appeal to the Treasury is also secured to any Accountant who may be dissatisfied with any disallowance which has been made in his Accounts by the Comptroller and Auditor-General. On the completion of the examination of the Accounts for the financial year, the Comptroller reports to the House of Commons on each of the Accounts submitted to him, and his criticisms are considered by certain members of the House who constitute the Public Accounts Committee.

With the duties of the Officials of His Majesty's Exchequer and Audit Department this work, however, is not concerned; like those of other servants of the Crown, the duties are prescribed by Acts of Parliament and by Rules and Regulations issued from time to time by the Authorities.

It is evident from the above remarks that the term "Public Accountant" was formerly applied to those Government officials who had to account to the Treasury for the manner in which they had expended public revenue entrusted to them. Towards the close of the eighteenth century, however, mercantile men and others who were unable, either by themselves or their clerks, to keep their books of account, or even, if the books were properly kept, to prepare statements from them, found it to their advantage to seek the aid of expert book-keepers, who were able to devote to this occupation some of their leisure time. In this way arose the growth and development of professional accountancy, the practising members of which were styled Public Accountants.

CHARTERED ACCOUNTANTS

The leading members practising in Scotland were successful in obtaining grants of Royal Charters, those practising in Edinburgh receiving one in 1854, followed by Glasgow in 1855, and Aberdeen

in 1867. The members of the Societies incorporated by these Charters, have since been known as "Chartered Accountants."

No similar steps appear to have been taken in England until 1870, when an institute of practising professional Accountants was formed. This institute was successful in obtaining a Royal Charter on 11th May, 1880.

In 1885 a society was formed by professional and other Accountants who were not eligible for membership of the Institute of Chartered Accountants. The society was registered under the Companies Act, 1862, as the "Society of Accountants and Auditors," and its members are known as "Incorporated Accountants."

In recent years, since the grant of the Royal Charter to the Institutes, other bodies of Accountants have been formed. The shareholders of public companies have gradually ceased to appoint, from their body, Auditors of their accounts, and have replaced the amateur Auditor by a Chartered, Incorporated, or other professional Accountant.

The vast sums of money embarked in joint stock enterprise in Great Britain have caused the position of those who audit the accounts of such enterprises to assume great importance, and the responsibility Attaching to the post of auditor of a public company is, consequently, very onerous.

INCREASE OF JOINT STOCK COMPANIES SINCE 2nd NOVEMBER 1862

Since the 2nd day of November, 1862, the day on which the Companies Act, 1862, came into operation, there has been a marked increase in the number of associations formed for enabling persons of all classes, trades, and denominations to combine together for the purpose of carrying on to their mutual advantage a single trade or any enterprise for the development of which the joint stock principle, as amended by the Act, offered increased facilities.

For a considerable time prior to the passing of this Act these associations had been in existence, but until 1844 they were subject to the law which governed ordinary partnerships of two or three persons, and the promoters of railway and other companies had the entire charge of their undertakings, made contracts with landowners and others, and issued prospectuses, on the faith of which subscriptions were received and certificates of shares issued without interference or control on the part of the legislature.

The first Joint Stock Companies Act (called the Joint Stock Companies Registration Act) was passed in 1844, and it remained in force until 1856, when it was repealed, except with regard to

insurance companies, for which companies it remained in force until the Companies Act, 1862, came into operation.

The first Act of Parliament making limited liability attainable by joint stock companies was passed in 1855, but this was not brought forward as an independent measure, and was in fact a graft on to the Act of 1844.

JOINT STOCK COMPANIES ACT, 1856

In 1856, however, Mr. Robert Lowe (afterwards Lord Sherbrooke), who was at that time the Vice-President of the Board of Trade, brought into the House of Commons the Joint Stock Companies Act, 1856, which repealed the previous Acts referred to, and reduced their provisions into a practical system. In 1857 and 1858 four additional Acts were passed, and in order to consolidate the Acts relating to joint stock companies Lord Chelmsford brought a fresh one in twice in 1859, but it did not pass, neither was Lord Campbell more successful in 1860. In 1862, however, the Act, which remained in force for forty-six years, and which gave so great an impetus to joint stock enterprise, was passed.

No provision, however, was made in this Act for the audit of accounts, although a schedule was attached, which was applicable to companies registered without Articles of Association, containing regulations as to audit for those particular companies only.

PROVISIONS FOR AUDIT IN ACT OF 1844

The omission of all reference in the Act of 1862 to the presentation of accounts to the shareholders, and their previous audit, is surprising, when it is borne in mind that eighteen years before it was evidently considered that legislation on this subject was desirable. In an Act entitled "An Act for the Registration, Incorporation, and Regulation of Joint Stock Companies," which received the Royal Assent on 5th September, 1844, very full clauses were inserted, providing for the proper keeping of accounts, the balancing of the books, the preparation of a Balance Sheet, the audit of the Balance Sheet, and the reporting thereon by the Auditors. It further enacted that a printed copy of the Balance Sheet and of the Auditors' Report should be sent ten days before the annual meeting to every shareholder and be filed, fourteen days after the meeting, with the Registrar of Joint Stock Companies.

Several Acts were subsequently passed which were supplemental to the Act of 1862, the first Act of importance to Chartered Accountants being the Act of 1879, which enacted that the accounts of every banking company registered after the passing of

the Act should be examined by an Auditor, and when within the following years many of the leading joint stock banks registered under this Act, they took the opportunity of displacing the shareholder-auditor and elected Chartered Accountants to the office.

ACT OF 1900

The Companies Act, 1900, enacted for the first time since the Act of 1844 that every company should have at least one Auditor, and prescribed his mode of appointment, and to a limited extent his rights and duties.

An entirely new provision was introduced into this Act by which, seven days before the statutory meeting of a new company, the Directors were required to send a report to each shareholder, which report, so far as it related to the shares allotted by the company, and to the cash received in respect of such shares, and to the receipts and payments of the company on capital account, had to be certified as correct by the Auditors, if any were appointed.

In 1907 a further Act, supplemental to the Act of 1862, was passed, which contained some important sections relating to Auditors and their duties, and a short Act was also passed early in 1908.

COMPANIES (CONSOLIDATION) ACT, 1908

As a result of this legislation, the law relating to limited liability companies had to be found in the Act of 1862 and in such a number of subsidiary Acts as to be of great inconvenience, both to professional men and to the public, and on the 21st December, 1908, an Act was passed repealing the Act of 1862, the subsidiary Acts referred to, and certain sections in a number of other Acts which applied to companies, and incorporating all the provisions of such sections of the Act of 1862 and the subsequent Acts which were in force, in one Act.

This Act, intituled "The Companies (Consolidated) Act, 1908," applied to all companies registered under the Companies Acts, 1862 to 1908, and to companies subsequently registered under the Act.

The Companies Act, 1929, superseded this Act and repealed the following Acts relating to limited companies—

The Companies (Consolidation) Act, 1908.

The Companies Act, 1913.

The Companies (Particulars as to Directors) Act, 1917.

The Companies Act, 1908.

The provisions of the Act so far as they affect Auditors will be set out in the appropriate chapters of this work.

ASSURANCE COMPANIES ACT, 1909

The Assurance Companies Act, 1909, enacts that the accounts of all assurance companies shall be deposited annually with the Board of Trade. Where the accounts of an assurance company carrying on an assurance business of all or any of the following classes: (*a*) Life Assurance, (*b*) Fire Insurance, (*c*) Accident Insurance, (*d*) Employers' Liability Insurance, (*e*) Bond Investment Business, are not subject to audit in accordance with the provisions of the Companies Act, 1929, or the Companies Clauses Consolidation Act, 1845, relating to audit, they shall be audited annually in such manner as the Board of Trade may prescribe, and the regulations made for the purpose may apply to any such company the provisions of the Companies Act relating to audit, subject to such adaptations and modifications as may appear necessary or expedient.

COMPANIES INCORPORATED BY SPECIAL ACTS

In addition to the companies registered under the Companies Act, 1929, there are those registered under various other public Acts (including railway companies, gas and water companies, building societies, friendly and industrial and provident societies, and savings banks), as also those incorporated by special Acts of Parliament. The latter are, naturally, subject to certain public Acts in addition to their own private Acts.

BUILDING SOCIETIES

The first building society was founded in 1809, and was followed by many others. Previously to 1836, no special legislation existed for them, and they were considered ordinary joint stock companies. About this time a proposal was made by the Chancellor of the Exchequer to charge a duty on shares in joint stock companies which were transferable. This alarmed the building societies, who protested so successfully against the proposed duty being applied to them that an Act was passed for their regulation, and although this Act was described by the Royal Commissioners as "one of the worst drawn which yet remain in the Statute-book," it remained in force for nearly forty years.

In 1874, the Building Societies Act, 1874 (37 & 38 Vict., c. 42), was passed, under which most of the building societies now in existence are incorporated; but as it does not affect societies registered under the Act of 1836, unless they become incorporated under the new Act, the provisions of the Act of 1874 do not apply to all building societies. The Act of 1836 is, however, by the Building Societies Act, 1894 (57 & 58 Vict., c. 47), repealed from the 25th August, 1896, as to societies certified thereunder after 1856.

The Act of 1894 prescribed that a form of accounts should be prepared by the Chief Registrar of Friendly Societies for use by Building Societies, and contain certain information; it also enacted that one of the Auditors of each Society should be a person who publicly carries on the business of an Accountant.

In the reports of the Chief Registrar of Friendly Societies for the year ending 31st December, 1894, presented to Parliament, that official states that a number of questions have been addressed to him as to who fulfils this requirement of the Act. In the opinion of the Registrar, a person who publicly carries on the business of an Accountant is one "who could, if required, under Section 21 of the Act, append to his signature as Auditor a statement that he is a person who publicly carries on, at some specified place, the business of an Accountant, and would be subject to the penalty provided by Section 22 of the Act if the statement should be proved to be false," and further, he adds, "It would seem that the turning-point of the definition in the Act lies in the word 'publicly,' and, therefore, that many men who possess excellent credentials as Accountants in private employ, or in positions where the public cannot come to them and give their accountancy work to them, are not within it. To put the matter in familiar terms, the essential part of the qualification is a brass plate or other public notification that the business of an Accountant is carried on."

SAVINGS BANKS

On the 11th July, 1817, was passed an Act for the purpose of encouraging the establishment of Banks for Savings in Ireland, and on the following day a similar Act was passed for the encouragement of Savings Banks in England, which Act was amended in the following year. Savings Banks were first legally recognized in Scotland in 1819 by the Act 59 Geo. III, c. 62.

The Act 1 Geo. IV, c. 83, altered the procedure of dealing with the funds of Savings Banks as an investment with the Commissioners for the Reduction of the National Debt at the Bank of England, and prescribed that receipts bearing interest at 3d. per cent per diem were to be given for moneys invested.

Under the Acts 5 Geo. IV, c. 62, and 9 Geo. IV, c. 92, the state of the law relative to trustee savings banks began to assume its present form, and the former of these Acts of Parliament was the earliest statute dealing with banks in both England and Ireland.

ACT OF 1844

Several Acts were passed in the reign of William IV, and an Act was passed in 1844 which, amongst other amendments of the law, prescribed that Auditors were to be appointed, and certain duties to be performed by them were specified. The depositors'

Pass Books were to contain a copy of the rules, which rules were to provide for the production of Pass Books for the purpose of their being inspected, examined, and verified. Acts were passed in 1854, 1859, and 1860, and in 1861 Post Office Savings Banks were first established.

ACT OF 1863

In 1863 so many Acts were in force relating to Savings Banks that a new Act was passed, known as the Trustee Savings Banks Act of 1863, which repealed, so far as trustee savings banks were concerned, all previous savings bank legislation, with the exception of the provisions contained in 24 Vict., c. 14, and 26 Vict., c. 14, and set forth in one measure the statutory enactments relating to trustee savings banks. This is still the chief Act of Parliament controlling the conduct and management of this class of savings bank. By this Act it was provided that a public Accountant or one or more Auditors was to be appointed by the Trustees and Managers, but not out of their own body, to examine the books of the bank and to report in writing to the Board or Committee of Management the result of such audit not less than once in every half-year; also to examine an extracted list of the depositors' balances, made up every year to the 20th November, and to certify as to the correct amount of liabilities and assets of the bank. It also prescribed that a book containing such extracted list of every depositor's balance, omitting the name, but giving the distinctive number and separate amount of each deposit, and showing the correct number and amount of the whole, checked and certified by such public Accountant or Auditors, should be open, at any time during the hours of public business, for the inspection of every depositor in relation to his own account.

ACTS OF 1880, 1887, AND 1891

A further Act was passed in 1880, and another one in 1887; and in 1891 was passed the Act for the establishment of an Inspection Committee of Trustee Savings Banks, which, in addition to giving certain powers to this Committee, also prescribed that if, in the opinion of the Committee, the rules of a savings bank are insufficient for the purpose of maintaining an efficient audit, the bank shall with all convenient speed make such additional rules as may, in the opinion of the Committee, be required for the purpose.

FRIENDLY SOCIETIES

A number of societies formed to encourage thrift are registered under the Friendly Societies Act, 1896, and supplementary Acts, and are required by Section 26 of this Act to submit their accounts

once at least in every year to one of the Public Auditors appointed by the Treasury, or to two or more Auditors appointed by the Society or each of its branches for the audit of the accounts of each branch.

AUDITOR'S POWER UNDER HEALTH ACTS

An Auditor, appointed by the Local Government Board under the Public Health Acts to audit the accounts of a Metropolitan Borough Council, is authorized and required by that Act to decide whether any member or official of the council has been guilty of negligence or misconduct in relation to the accounts whereby a loss has been incurred by the council, and to assess the amount of the loss. The auditor of a company does not possess such powers, but it is open to shareholders to take legal steps against the Directors as a result of the Auditor's report in connexion with the periodical accounts issued to the shareholders, and it may be useful to quote the remarks of the late Lord Moulton, when L.J., referring to the powers of an Auditor of the Local Government Board, as it may be deduced from this judgment that the persons accounting to the Auditor of a company are the Directors, and it is not the duty of the Auditor to inquire into the negligence or misconduct of an official which he may encounter during the course of his audit. He may make a report to the Directors, leaving them to deal with the offending official.

The following is the case referred to—

R. v. Carson Roberts

On an application for a certiorari under Section 247, Subsection 8 of the Public Health Act, 1875, to remove and quash disallowances and surcharges made by an Auditor acting in pursuance of that section, the jurisdiction of the Court is not confined to error in point of law, but extends to error in point of fact.

So *held* by the Court of Appeal, [1908] 1 K.B. 407, affirming the decision of the Divisional Court, [1907] 2 K.B. 878.

R. v. *Haslehurst* (1887), 51 J.P. 645, followed and approved.

Per Cozens-Hardy, M.R., and Farwell, L.J. An Auditor appointed by the Local Government Board under Section 247 of the Public Health Act, 1875, to audit the accounts of a Metropolitan Borough Council is authorized and required by Subsection 7 to decide whether any member or officer of the Council has been guilty of negligence or misconduct in relation to the accounts whereby the loss has been occasioned to the Council, and to assess the amount of the loss.

Per Fletcher Moulton, L.J. The powers and duties of the Auditor under Subsection 7 of Section 247 are strictly confined to auditing, and the words "person accounting" in the latter part of that Subsection, which requires the Auditor to "charge against any person accounting the amount of any deficiency or loss incurred by the negligence or misconduct of that person," mean the person who brings in accounts for audit. Therefore, where the accounts submitted for audit are the accounts of a Metropolitan Borough Council the person accounting is the Council, and the Auditor has no power to inquire into the negligence or misconduct of the individual members or servants of the Council.

AUDITORS OF UNIVERSITIES AND COLLEGES

The Universities of Oxford and Cambridge Act, 1877 (40 & 41 Vict., c. 48), enacted that the Commissioners for each University appointed by the Act should in Statutes made by them make provision for the audit of the accounts of the University and of its Colleges, and accordingly the University of Oxford Commissioners made a Statute on the 16th June, 1881, that the Hebdomadal Council should annually appoint a University Auditor, who must be either a professional Accountant carrying on business in London or Westminster, or (if they think fit) a person conversant with accounts approved by the Permanent Secretary to the Treasury. Nearly if not all the colleges have statutes to the same effect for the audit of the college accounts, and consequently the accounts of the University Chest and of the Colleges of Oxford referred to are audited by Chartered Accountants.

In conferring the honorary degree of M.A. on a Chartered Accountant who for many years had acted as Auditor of the University Accounts, the following was the Public Orator's felicitous account of the duties discharged by him: "Sexcenta fere sunt, quae ad calculos sunt vocanda—vectigalia, impensae, reditus, praediorum mercedulae, pignora, hypothecae, usurae, decumae, reparationes atque hujusmodi caetera; his accedunt pecuniae fiduciariae quae in proprios usus debent asservari. Quae quidem omnia non cujusvis est hominis digerere, discutere, inter se compensare. Postulat animi experientiam, postulat ingenii acumen, fidem incorruptam." ["The things which have to be brought to a strict account are almost beyond number—taxes, outlays, returns, revenues from estates, mortgages, securities, interest, tithes, purchases and all other things of this kind: in addition there is money held in trust which must be kept to gain the interest due on it. All of which it is not in the power of any man to handle, or examine, or balance. It requires a trained mind, a keen intellect, and complete trustworthiness."]

This Act was followed by the Universities of Oxford and Cambridge Act, 1923, making further provisions as to the form of Accounts and the audit and publication thereof.

The following certificate to be signed by the Auditor or Auditors was prescribed—

> We hereby certify that the accounts are duly kept in the form prescribed by University Statute, that the foregoing Revenue and Capital Accounts and the Statement of Revenue Balances are correct, and that these Accounts and the Statement of Revenue Balances represent a true statement of the affairs of the College according to the best of our information and the explanations given to us and as shown by the Books of the College. We also certify that (according to the best of our information) the items of Account are compiled in accordance with the rules at this present time prescribed by the Statutory Committee of Bursars set up in accordance

with the Statutes of the University made in this behalf by the Statutory Commissioners under the Universities of Oxford and Cambridge Act, 1923.

Various rules were laid down as to the obligations of colleges regarding Kitchen Management, one of which is as follows—

To nominate in each third year for approval by the Curators of the University Chest a Firm of Accountants, being Chartered Accountants actually carrying on business and not being Accountants who audit the accounts of any College or Society in the University, to carry out the inspections hereinbefore mentioned. The Accountants shall be Accountants who have had experience in the auditing of the accounts of firms or Institutions engaged in catering. The Accountants shall examine the accounts, statistics, and methods of catering administration in each College once in every period of three years.

Very full details as to the Oxford Colleges are to be found in a publication called *Statuta et Decreta Universitatis Oxoniensis* published in 1927. The accounts of the Universities of Cambridge Colleges are now audited by professional accountants.

AUDIT OF ACCOUNTS OF CONSERVATORS

By the Salmon Fishery Act, 1865 (28 & 29 Vict., c. 121, s. 29), an account of the receipts and disbursements of every Board of Conservators, in such form and with such particulars as may be required by the Court of Quarter Sessions that appoints the Board, or any case of a Joint Board by the Court of Quarter Sessions of the Audit County, shall be laid annually before such Courts of Quarter Sessions as aforesaid, and the Justices assembled at such Courts may disallow any item that they consider to be illegal.

COUNTY ASSOCIATIONS

By the Territorial and Reserve Forces Act, 1907 (7 Edw. VII, c. 9), the accounts of county associations are required to be made up annually and audited.

PORT OF LONDON

By the Port of London Act, 1908 (8 Edw. VII, c. 68), the accounts of the Port of London Authority, and of its Committees, are to be made up annually and audited by an Auditor to be appointed by the Board of Trade.

AUDIT OF ACCOUNTS OF JUDICIAL TRUSTEES

By the Judicial Trustees Act, 1896 (59 & 60 Vict., c. 35, s. 17), the accounts of every trust of which a judicial trustee has been appointed are required to be audited, and a report thereon made to the Court by the prescribed persons, and by the rules made under this Act the person to audit these accounts shall be an Officer of the Court, but the Court, if it considers that the accounts

are likely to involve questions of difficulty, may refer them to a professional Accountant for report.

ACCOUNTS OF CHARITIES

Notwithstanding the defalcations which occur from time to time of Charitable Funds, no law has yet been passed to compel all such institutions seeking subscriptions from the public to submit their accounts to professional Auditors, but the Boards of Management of King Edward VII's Hospital Fund and of the Hospital Sunday and Hospital Saturday Funds will not make any awards to those institutions which do not present their accounts in a prescribed form duly certified by a professional Auditor.

As a result, however, of the great European War a number of Charities were formed to relieve the distress of civilians and sailors and soldiers in the countries of our Allies and in the United Kingdom. These became so numerous that the War Charities Act, 1916, was passed requiring such Charitable Societies to be registered, to keep proper accounts, and to have these accounts audited at such intervals as might be prescribed by regulations under this Act.

AUDITORS OF ACCOUNTS OF MERCHANTS

At present there is no legal obligation on merchants and others, trading either alone or in co-partnership with others, to submit their accounts periodically to Auditors; the practice, however, of doing so voluntarily is becoming very general. The certificate of a professional Auditor is useful in many ways. In addition to the moral effect of the periodical visit of a professional Auditor on the cashier and other members of the staff, questions of Income Tax, adjustments of accounts between partners (especially where the management of affairs is left to one or only some of the partners), negotiation of loans from bankers and others, are all more easily arranged.

In the event of the death of a partner, or the dissolution of the partnership either by consent or by effluxion of time, the fact that the accounts have been periodically audited is of the greatest assistance in the settlement between the various parties interested.

Every partner has a right to have accurate accounts kept and to have free access to them.—*Rowe* v. *Wood* (1822), 2 Jac. & W. 558; *Goodman* v. *Whitcomb* (1814), 3 V. & B. 36.

The Limited Partnerships Act, 1907, Section 6, Subsection (1), gives power to a limited partner to employ an Auditor to inspect, as his agent, the books of a firm in which he is a limited partner, and examine into the state and prospects of the partnership business.

It is a common occurrence for persons to advance money to

others in business, receiving either a fixed rate of interest or a share of the profits, or both, without taking any part in the management of the business. In these cases it is most important more especially on behalf of the limited partner, that the accounts be periodically audited.

AUDITORS ON BEHALF OF SLEEPING PARTNERS

It is frequently arranged, in these circumstances, that the accounts as certified by the Auditor shall be binding on all parties. When this is the case, the Auditor should be made aware of the fact, otherwise a new account may have to be taken.

In a case decided by the House of Lords, taken on appeal from a judgment by the First Division of the Court of Session, Scotland, the appellant had advanced £15,000 to the respondent, to be used in the business of the respondent for five years. In return for the advance, the appellant was to receive interest and 37½ per cent of the profits of the respondent's business. The contract stipulated that there should be an annual audit of the respondent's business by a firm of Chartered Accountants, and that their certificate as to the profits should be binding on both parties. For four years the respondent's books were audited by a member of the firm of Chartered Accountants. Subsequently the appellant raised this action against the respondent for a Judicial Account, on the ground that the audits had not been in terms of the agreement, in that the Auditor did not know that his estimate of the profits was to be binding on the appellant and respondent. The Auditor swore in his evidence that he did not know of this agreement, and that, if he had, he would have made the account in a somewhat different form. The House of Lords held that there must be a new account taken, the Auditor being unaware that his audit was to be final between the parties.—*Teacher* v. *Calder*, [1899] A.C. 451.

AUDIT OF ACCOUNTS OF EXECUTORS AND TRUSTEES

Persons interested under a will are not usually content nowadays to accept what may be handed to them without the certificate of a professional Auditor that the amount has been ascertained after an examination of the books and papers of the Executors and Trustees, while Executors and Trustees themselves are entitled on their own initiative to employ Chartered Accountants to audit their accounts.

The desirability of their doing so is clearly indicated in a case where a Trustee, who was himself one of the beneficiaries had inadvertently overpaid the other beneficiaries their share of income, and died before any adjustment had been made. It was held that the Executors of the deceased Trustee were not entitled

to recover from the other beneficiaries the amount so overpaid, or to have accrued or future income impounded till the shares were equalized, by reason of the fact that the testator himself was the person responsible for the mistake that had been made.—*In re Horne : Wilson* v. *Cox Sinclair*, [1905] 1 Ch. 76.

AUDIT OF OTHER TRUST ACCOUNTS

By the Public Trustee Act, 1906 (6 Edw. VII., c. 55, s. 13), the accounts of any trust may, subject to notice being given in the prescribed manner, be investigated and audited by a professional Accountant, as may be agreed upon by the applicant and the trustees, or, in default of agreement, by the Public Trustee or some person appointed by him.

AUDIT OF ACCOUNTS OF LANDED PROPERTIES

The proprietors of landed estates, as a rule, require the books of their Agents to be submitted to a professional Auditor for the purpose of ascertaining that their rents and other revenues are collected and accounted for.

Many persons also now entrust to Auditors the examination of the accounts of their private businesses, or, when not engaged in business, of their private investments, and even of their household expenses.

AUDITOR APPOINTED ADMINISTRATOR

Where all parties interested in the estate of a deceased person had entered into a compromise, with a view to putting an end to all further disputes and litigation, upon the basis that a Chartered Accountant, a stranger in blood, who had been employed by the deceased in auditing his accounts, should apply for and obtain a grant of Letters of Administration, with the will and codicils annexed, the Court, upon his application, and subject to the consents of all the persons interested in the estate, and subject to an affidavit of the fitness of the proposed Administrator being filed, made the grant to him under the Probate Act, 1857, s. 73.—*In the Goods of Potter, Potter* v. *Potter*, [1899] P. 265.

AUDITOR AS ASSESSOR

An Auditor is sometimes appointed under a policy of fire insurance as an Assessor to settle the amount payable where, by reason of a fire, the turnover of the business has decreased. By a policy of insurance against fire on business premises an insurance company agreed to pay to the insured, in the event of damage by fire to their property on account of annual net profit, an agreed percentage on the amount by which the turnover in each month after the fire should in consequence of the fire be less than the

turnover for the corresponding month of the year preceding the fire. The policy further provided that the amount of all losses under the policy should be assessed by the insured's Auditors. During the currency of the policy property of the insured was damaged by fire. The Auditors gave certificates stating the difference between the turnover for the months after, and the corresponding months in the year before the fire, and the percentage payable. An arbitration was held to determine the amount payable under the policy. The Auditors' certificates were put in evidence, and a member of the firm of Auditors was called as a witness by the insured and stated that when he gave the certificates he was satisfied that the losses of turnover stated therein were in fact sustained in consequence of the fire.

Held, that the assessments of the Auditor were conclusive evidence of the amount of the loss recoverable under the policy unless it were shown that the Auditor had misdirected himself in point of law or had omitted to take into consideration some material fact; and that the Auditor might be cross-examined, and the insurance company might call direct evidence, to show that the Auditor had omitted to take into consideration the fact that the losses of turnover were wholly or in part due to other causes than the fire, but not to show that the Auditor's conclusions of fact were erroneous.—*Recher & Co.* v. *North British and Mercantile Insurance Company*, [1915] 3 K.B. 277.

The great majority of undertakings in the United Kingdom now take the form of limited liability companies administered by a board of directors.

At the end of each financial year and in some cases at the end of each half-year the Directors submit a Balance Sheet drawn up for the approval and adoption of the shareholders.

The function of the Auditor is to examine the Balance Sheet with the books of the company and to make a Report to the shareholders in the prescribed form with such variations as may be necessary in any particular case.

The object of this treatise is to set out the duties, responsibilities and methods of procedure of the Auditors.

As regards auditing generally, whether it be of companies, societies, trusts or partnerships, it is no part of the Auditor's duty to interfere in the management, but only to see that the results of the year's administration by the accounting parties are correctly shown in the accounts according to the best of his knowledge and belief.

CHAPTER II

THE OBJECT OF AN AUDIT

THE object of an audit is to establish by an examination of the books, vouchers, and other appropriate records, that a Balance Sheet at a given date exhibits a true and correct view of the state of affairs of the undertaking, whether it be an incorporated company, trust, partnership, or other body. The Auditor should satisfy himself that the accounts submitted to him are correct in principle and in accordance with the facts as disclosed by the books and other records, and report accordingly. If he is not satisfied he should point out what he considers to be wrong in principle or in fact.

The extent of the Auditor's duty is determined by statute or by his instructions. In some cases, as, for example, in the case of companies incorporated under the Companies Act, 1929, where it is provided by law that he must report on certain facts, it is necessary for him to make an examination which will enable him to give that report. In other cases, where he acts for individuals or firms, he should be instructed as to the scope of the audit required. He then will limit his work accordingly, taking care, if he is prudent, to receive his detailed instructions in writing, so that no question as to the duties he has undertaken may be raised at a later stage.

The main considerations arising in the majority of audits may be summarized as follows—

(1) To verify the accuracy of the books and of the transactions recorded in the books, and to ensure that the transactions are proper to be included as well as being correctly entered.

(2) To ensure that a proper distinction has been made between items chargeable to Capital and items chargeable to Income. (This is of the essence of an audit and a vital point.)

(3) The verification, so far as is within the reasonable power of the Auditor, of the existence of the assets and liabilities appearing in the Balance Sheet.

(4) To ensure that the items in the Balance Sheet and accounts are so described as to give a sufficiently clear and correct view of their nature.

It is obviously the duty of Directors, Partners, Trustees or others, submitting the accounts for audit, so to conduct and arrange the affairs of the body for which they are responsible that the possibilities of fraud are reduced to a minimum. If these responsibilities are recognized and an effective internal control is in operation, the duties of the Auditor are considerably lessened and the routine work which he feels obliged to undertake may be curtailed.

In theory the Auditor should audit accounts which have already been prepared by his clients. In practice, in many cases, the Auditor is asked to raise the accounts from the books and even to make the closing entries. In performing this work, the Auditor is acting as an accountant; the work is not audit work and frequently a special fee is paid for it. However, such a course does have the effect of reducing the work on the audit, for entries made by the Auditor himself are verified at first hand.

It is important to bear in mind that the statutory and other duties of Auditors do not affect the obligations and duties of the Directors. It is the duty of the Directors to have proper books kept, and the Balance Sheet and accounts prepared therefrom, and to decide in what form the accounts are to be presented to the shareholders. Although the Auditor may suggest to the Directors some alteration in the form of the accounts which may appear to him to be advisable or necessary, he cannot enforce any alteration. The duty of the Auditor is to report to the shareholders on the accounts which are submitted to them at the annual general meeting, and to refer to any matter on which he is not satisfied, and which he feels should be brought to their notice. On the other hand, the shareholders in general meeting may ask for explanations and, subject to the Articles of Association, may by resolution decide on the form to be adopted in the presentation of the accounts.

The Auditor's report to the shareholders is referred to more in detail in Chapter IX. Where the Auditor is in every way satisfied in regard to the contents of the Balance Sheet he will make the conventional report which conforms to the wording used in Section 134 (1) (*a*) and (*b*) of the Companies Act, 1929 (or any other statute applying to the undertaking in question), defining the requirements of the Auditor's report. Any variation of this wording attracts the attention of the shareholders and others who are familiar with the form in which accounts are presented, for it may mean that the Auditor has considered it necessary to call attention to some matter as to which he is not satisfied, and which the Directors have not made clear in the accounts. Directors are, as a rule, willing to consider the Auditor's advice as to the form of presentation of the accounts and the Auditor should advise that if such information is given on the face of the accounts he will regard it as unnecessary to make any qualification of his report. It is well known by the professional and commercial community that this is the usual procedure, and it is for this reason that any qualification in the Auditor's report is given special weight. The Auditor should only qualify his report after the most careful consideration of the facts and the interests of the shareholders.

The omission or neglect of a Trustee, Director, or Manager to

comply with statutory provisions as to audit may constitute misfeasance.—*Davies's Case, re Cardiff Savings Bank* (1890), 45 Ch. D. 537.

The routine of a detailed audit in general matters is dealt with in Chapters III, IV, V, and VI, and points arising in special matters in Chapter XVII.

CHAPTER III

AUDITOR'S REGISTER OF AUDITS, RECORDS, NOTES, AND ROUTINE WORK

A REGISTER of Audits, containing the name of each audit and the date to which the accounts are made up should be kept, arranged in alphabetical order and recording the number of the audit file of papers relating to the audit. The audit files should be numbered in consecutive order and when not in use stored away in that order. It may be more convenient to have bankers' and other certificates and verification forms filed in the correspondence file relating to the audit; these files should be kept in a filing cabinet and arranged in alphabetical order, or in the filing box with other papers of the audit.

AUDIT FILES OF PAPERS

Separate records should be kept for each audit comprising—

1. Information of a permanent nature.
2. Instructions as to routine work.
3. Queries arising in the course of the audit and replies thereto.

For these records it is convenient to use foolscap books or loose foolscap sheets which, when bound together, form a complete file as to the audit.

1. Information of a Permanent Nature

As regards companies—

Name of company.
The objects of the company.
Address of Registered Office.
Date of registration of company.
Date entitled to commence business.
Names of Directors.
Qualification in shares required to be held by Directors.
Names of Secretary, Solicitors and Bankers.
Complete list of books kept, names of staff responsible for the books and transactions and their respective duties, and the system of internal control adopted to guard against error or fraud.

By reference to the prospectus, or statement in lieu of prospectus, and Memorandum and Articles of Association and Debenture Trust Deed (if any) and Minutes of Board Meeting—

Qualification and remuneration of Directors. (This is not required to be disclosed in statement in lieu.)
Agreements with Directors, Managing Directors and others for remuneration, salaries, and commission.

Amount of purchase money, how to be satisfied, and amount of goodwill.

Short particulars of material contracts and particulars of debentures or shares to be issued otherwise than for cash.

Underwriting commission (which must be stated in prospectus or statement in lieu, and authorized by the Articles of Association).

Minimum subscription upon which the company may go to allotment.

A summary of all investments whether in property, debentures, or shares, or loans on security.

The powers of the Directors, and their authority (if any) to delegate to others, and how many make a quorum of the Board.

Note. A Director who may not vote because of a personal interest in any matter under consideration must not be taken into account in reckoning a quorum.

The company's borrowing powers, and how they may be exercised.

Summaries of all binding contracts referred to in the prospectus, Memorandum and Articles of Association, or Minutes of the Directors.

Note. The Memorandum and Articles override the prospectus should there be any variation.

A summary of the authorized debenture issue (if any), what is charged to the debentures, how and when repayable and at what premium (if any), the rate of interest, and the remuneration payable to the trustees for the debenture-holders. Similar particulars of any mortgages which have been created. A summary of the classes of share capital (whether Preference, Redeemable Preference, Ordinary, Deferred, or Founders' Shares), or shares issued at a discount, and of the specific rights as to dividend attaching to each class, stating whether dividends are payable on the amount paid up in respect of share capital, or as is unusual upon the nominal amount of capital issued.

A summary of any articles, or regulations of Table A if applicable, relating to the accounts and the Auditors, paying due regard to Sections 122 to 134 of the Companies Act, 1929, so far as they relate to Auditors. (These Sections will be considered under their appropriate headings.)

As regards Partnerships—

Names of partners.
Date of Partnership Deed.
Duration of Partnership.
Capital to be contributed by each partner.
Rate of interest on capital and drawings.
Rate of interest on loans made by partners in addition to capital.
Division of profits.
Provisions as to drawings.
Dissolution provisions.

As regards Trust Estates—

Names of trustees.
Date of Will.
Précis of general provisions of the Will.

Summary of Estate Duty Affidavit and Corrective Affidavits (if any).
Summary of Legacies and conditions attaching thereto.
Directions as to division of Income and Residue.
Summary of special legal decisions and rules thereunder which may have to be observed according to the conditions of the Will or of the Estate.

The foregoing particulars should be recorded at the first audit and be revised so far as necessary at each periodical audit, regard being paid to any subsequent Act of Parliament requiring additional books to be kept for any purpose.

At the commencement of the audit, unless it be a continuous audit, the Auditor should have before him the Balance Sheet upon which he is asked to report, with Schedules showing how the various items are made up. He should also have the Profit and Loss Account, the balance of which is one of the items in the Balance Sheet, and the Trading Account showing how the balance of gross profit or loss transferred to the Profit and Loss Account has been ascertained. After a scrutiny of the Balance Sheet and Schedules and of the books relating thereto, the Auditor decides what work is necessary to test the accuracy of the books and the accounts, prepares the necessary records and settles the routine work. Equally if he has to agree the books and prepare the accounts himself, he will make similar records and settle the routine work for future reference.

2. Routine Work—Checking the Books

The checking of the books will be dealt with in more detail in later chapters. On undertaking an audit for the first time, the Auditor should obtain from a responsible official a list of the books in use. The extent of the detailed work will depend upon the nature of the audit, the system of internal control in force and the facilities for proving the totals in the books. The Auditor must exercise his judgment in determining how much detail work to do. Detailed checking includes testing the correctness of the posting of items from Day Books, Journals, Cash Books, and other subsidiary books to the appropriate Ledgers. The respective items should be ticked in each book and it must be seen not only that the amount is correct but that it is posted to the correct account and to the proper side of the Ledger. The additions (or "casts") of the various books should be checked or tested, and if they are numerous a saving of time is effected by the use of an adding machine. Varying forms of ticks should be adopted to denote the checking of additions, postings, cross entries, and vouching. The ticks should be made in coloured ink and it is helpful, from the point of view both of control and of facility in balancing the books, to change the colour in each year or other balancing period. Change of colour in ink often assists the later

detection of errors. If a figure has been altered before the audit the Auditor should himself write the figure in his coloured ink beside his tick or make a special tick to show that it is the altered figure which has been checked. A figure should not be altered by the client's staff after it has been checked by the Auditor; if any such alteration is found by the Auditor he should at once examine it; it may be a proper correction, but it may on the other hand be fraudulent.

The extent to which checking need be done depends in some measure upon the manner in which the books have been kept. Where checking by the Auditor is curtailed, it should be varied from year to year, and at each audit a sufficient all-round test made. In this way the Auditor satisfies himself, so far as he reasonably can, that the books submitted to him are correct. Checking of this nature cannot, in the nature of things, be more than a test. The Auditor's work can be materially lightened by expert book-keeping on the part of his clients. The present-day trend towards greater analysis—columnar and otherwise—in books of prime entry saves a great deal of posting in detail to the ledgers and enables the Auditor to satisfy himself more readily that the various items have been posted to the correct accounts.

The tedium of ticking postings and checking casts may sometimes be avoided by applying other tests of a more comprehensive nature. For instance, in the case of rents receivable a duly authenticated rent-roll will show the total which ought to be received. Where the columnar system of book-keeping is in use the total rents received can be readily ascertained from the Cash Book. By adding the receipts to the arrears, at the end of the year, and deducting the arrears at the beginning of the year, a complete agreement of totals should be reached. To arrive at this agreement will usually take less time than ticking and casting the Rent Ledgers, but it is necessary to ensure that the amounts in arrear are in order and to trace the rents received through the Cash Book to the bank. The same principle may be applied to rents payable. To take another example, it is possible in the case of Insurance Companies to obtain an independent statement of the premiums which ought to have been collected in any year, and to agree that figure with the cash received, together with the agents' and other balances outstanding, and so prove the accuracy of the cash received in respect of premiums, instead of ticking off the whole of the ledgers and examining countless counterfoil receipts. In making agreements of this type the facts are likely to be sifted much more closely than by ticking and casting. An expert auditor will usually adopt these more incisive methods where it is possible to do so, but it will be appreciated that although totals may be proved in this way compensating errors

and frauds as between one account and another will not be detected.

The balancing of the books is not infrequently left to the Auditors. "Method in the Balancing of Books" is the subject of Chapter XXIV, for this is a matter in which the Auditor should be an expert, and able to point out to his clients any defect in their book-keeping system.

CHAPTER IV

EXAMINING THE LEDGER BALANCES FROM WHICH THE BALANCE SHEET AND ACCOUNTS ARE RAISED

THE routine of checking having been completed, the next step is a considered scrutiny of the various Ledger accounts and balances, paying regard to any legal considerations arising thereon. These matters are dealt with in the following pages. To facilitate reference they are arranged in alphabetical order as follows—

Bank Charges and Bank Interest.
Bills Payable.
Bills Receivable.
Branch Returns.
Calls in Advance.
Cash Balances, Petty Cash, and Floats.
Commission.
Corporation Duty.
Debentures and Borrowed Moneys.
Debenture Interest.
Depreciation.
Directors and their Remuneration.
Directors' Travelling Expenses and other outlays.
Discounts.
Dividends.
Drawings and Patterns.
Foreign Exchange.
Forfeited Shares.
Forward Contracts.
Freight and Carriage.
Goodwill.
Income Tax.
Insurance, and National Health Insurance.
Interest during construction charged to capital.
Interest on Bank Deposits (see Bank Charges and Interest).
Leasehold Property Concessions, etc.
Loans by Companies.
Loose Tools.
Patents.
Plant and Machinery, Engines, Furniture and Fittings.
Preliminary Expenses.
Premium on Shares.
Professional Charges—
  Accountants.
  Estate Agents.
  Patent Agents.
  Solicitors.
Purchases.
Rates and Taxes.
Rents and Ground Rents receivable or payable.
Repairs and Renewals.
Royalties.

Salaries.
Sales, Consignments, etc.
Stock in Trade.
Stocks and Shares.
Subscriptions to Trade Societies and Charities.
Sundry Expenses.
Trade Debtors.
Trade Creditors.
Transfer Fees.
Wages.
Work in Progress.

BANK CHARGES

The comparison and agreement of the Cash Book and Bank Book (see page 94) ensures that all bank charges and interest receivable or payable appearing in the Pass Book are duly entered up and taken into account. Where accounts are made up at irregular or intermediate dates, a reserve should be made for such charges as may be outstanding.

BILLS PAYABLE

The balance of this account should be agreed with a list prepared from the Bills Payable Book of bills payable not due, or not taken up at the date of the Balance Sheet, and therefore not marked off as paid in the Bills Payable Book. The individual items in the Bills Payable Account can readily be checked with the bills not marked off as paid in the Bills Payable Book. If the bills are few in number it is usually convenient to insert in the Ledger a list of outstanding bills the total of which will agree with the balance on the account. By the date of the audit probably a number of bills will have matured, and those which have been paid may be inspected by the Auditor and marked by him as having been produced to him.

The balance due on bills payable at the date of the Balance Sheet is a liability of the business and is usually shown separately. The Auditor should satisfy himself that the amount of the individual bills has been duly debited to the accounts of the appropriate creditors.

If suitably ruled, the Bills Payable Book may be treated as a Ledger account. The bills are recorded on the credit side and posted to the debit of the drawer. The cash payments are posted against the bills, the difference between the two sides being the balance outstanding on bills payable which is agreed with the total of the bills which have not been paid.

BILLS RECEIVABLE

The balance of the Bills Receivable Account should be agreed with the total of the bills on hand at the close of the year; the

bills themselves should be inspected, or if they are held by the bank a certificate from the bank should be produced. If any bills which were on hand at the close of the year have been discounted before the date of audit, the proceeds should be traced to the Cash Book and Bank Pass Book.

There is a contingent liability on the drawer or an endorser in respect of bills receivable discounted which have not matured at the date of the Balance Sheet, arising out of the possibility that they may not be met by the acceptor at maturity. A list of these bills should be prepared and a note should be made on the Balance Sheet that there is a contingent liability in respect of bills under discount totalling £———.

The Auditor should see that bills receivable have been posted to the credit of the acceptor and that the bills are prima facie good, applying the tests mentioned under "Trade Debtors." As in the case of debtors, a reserve should be made for the amount of any bill likely to be dishonoured at maturity. The Auditor should inspect the books between the date of the Balance Sheet and the audit to verify that all bills maturing in that period have been met, or if not that a reserve has been made.

When bills of exchange are received from debtors, they may either be retained until maturity or discounted before maturity. In the latter case the holder receives a smaller sum than the face value of the bill, the difference depending on the current bank rate of discount and the period which the bill has still to run.

The amount received will be vouched by reference to the Bank Pass Book.

As explained under the heading "Bills Payable," the Bills Receivable Book, suitably ruled, may be used as a Ledger account.

BRANCH RETURNS

These returns take various forms. Head Office sometimes requires a copy of all the branch books with supporting vouchers. The accounts are then raised at the Head Office. In other cases returns, certified by a responsible person and if possible audited by a local Auditor (especially where the branches are abroad), are submitted. Where there are local Auditors available, a Balance Sheet and Accounts with the Auditor's report are sent to the Head Office and incorporated in the Head Office accounts. The Auditor naturally refers in his report to the fact that the accounts include the certified returns. He should agree the accounts between the Head Office and the respective branches.

He should also satisfy himself that the foreign exchange has been dealt with in a proper manner and on the same principle from year to year. If any material change is made it should

Summary of Postings

.... Branch

SUMMARY OF POSTINGS FOR .... 19 .

CASH RECEIVED	£	s.	d.	Previous Year £
Balance at Bank				
Customers				
Staff				
Cash Sales				
Bills Receivable, discounted				
From H.O. and Branches—				
Johannesburg				
Pretoria				
Sundry Receipts, viz.—				
Total				

CASH PAID	Cash £	s.	d.	Petty Cash £	s.	d.	Previous Year £
Bills Payable							
Customers							
Staff							
Sundry Creditors							
Cash Purchases							
Petty Cash							
Duties							
Forwarding, Railage and Cartage							
General Expenses, Charges, etc.							
Discount on Bills							
Interest							
Exchange							
Licences							
Insurance							
Head Office							
Sundries, viz.—							
....							
...							
....							
Total							

SALES	Sales £	s.	d.	Returns £	s.	d.	Previous Year £
Customers							
Staff							
To Head Office and Branches—							
London							
Johannesburg							
Pretoria							
. . .							
. . .							
(Cash Sales, £) . . .							
Total							

PURCHASES	Returns £	s.	d.	Purchases £	s.	d.	Previous Year £
From Head Office and Branches—							
Head Office							
Johannesburg							
Pretoria							
. . .							
. . .							
Local and Colonial Creditors . . .							
Total							
Cash Purchases . . . . £ Duties . . . . . £ Forwarding, Railage and Cartage £							

BILLS RECEIVABLE	£	s.	d.	Previous Year £
Customers				
Head Office and Branches—				
. . . . .				
. . . . .				
Total				

BILLS PAYABLE	£	s.	d.	Previous Year £
Sundry Creditors				
Head Office and Branches—				
London				
Johannesburg				
Pretoria				
..				
...				
Total				

JOURNAL	Total Debit £	s.	d.	Total Credit £	s.	d.	Previous Year Dr.	Cr.
Salaries								
Wages								
Sundry Creditors								
Sundry Customers								
Forwarding Charges								
General Expenses, Charges, etc.								
Licences								
Insurance								
Commission								
Sundries, viz.—								
....								
....								
Head Office and Branches—								
London								
Johannesburg								
Pretoria								
... .								
....								
Total								

SUMMARY OF EXPENSES FOR........... .. ..19. . ...

	Cash paid and P. Cash			Journal			Total			Previous Year
	£	s.	d.	£	s.	d.	£	s.	d.	£
Licences . . .										
Salaries . . .										
Insurance . . .										
Interest and Exchange .										
Commission . . .										
Bad Debts . . .										
Sundry Expenses . .										
Sundries, viz.—										
....										
....										
Total .										

be explained in the accounts or referred to in the Auditor's report.

The system of branch returns printed on pages 30–33, if effectively carried out, enables a summarized Ledger Account to be kept for each branch at the Head Office and enables accounts to be prepared quickly at the end of the accounting period. It is obvious that the audit of Branch Accounts abroad cannot as a rule be carried out from Head Office. Where the mail takes some weeks to and fro, it is impossible to get queries answered in a reasonable time. If possible, the summaries referred to should be examined from time to time by a local Auditor or by a travelling Auditor appointed by Head Office, who would visit the branches periodically, and certify the summaries.

CASH BALANCES, PETTY CASH, AND FLOATS

The cash balances in most undertakings consist of petty cash balances and various floats. Unless the amount be trifling, it is convenient that the cash be counted on the last day of the year, or period to which the accounts relate. If, however, the counting takes place at the date of the audit, the Cash Book and the Petty Cash Book should be written up to date, the Cash Book compared with the Bank Book and the respective balances agreed at the time when the counting takes place. If the petty cash balances and the floats be paid into the Bank on the last day of the year or period to which the accounts relate, the counting of the money can be avoided; this is especially convenient in the case of audits in the country. In these cases a cheque is drawn to re-open the Petty Cash Account and re-establish the floats. In many ways it is more satisfactory to count the cash at unexpected dates, for it is possible for a fraudulent cashier to borrow or otherwise obtain

possession of money, for a day or so, the amount so obtained being paid into bank and withdrawn on the following day.

If the cash and petty cash balances or floats are increasing from year to year, this should be looked into and explanations obtained, and in particular it should be ascertained that the maximum cash balance does not greatly exceed the expenditure which it is intended to meet from time to time.

When examining the cash in hand the Auditor may find that part of the balance consists of payments made in advance to clerks for salaries, to be repaid when the monthly or weekly salary is due and other small advances; the Auditor must satisfy himself that these advances are properly authorized, and he may consider it desirable in such circumstances to report to the Board how the cash balance is constituted. Where possible petty cash should be operated on the imprest system, as to which see "Vouching and Verifying the Cash," Chapter V.

CALLS IN ADVANCE

The Articles of Association of companies registered under the Companies Acts, usually authorize the Directors to receive from any member willing to advance it, all or part of the money uncalled or unpaid upon the shares held by him, and to pay interest on the money so paid in advance at an agreed rate. Table "A" contains such a clause, and provides that the interest must not exceed 6 per cent per annum, unless a higher rate has been sanctioned by the company in general meeting.

(*a*) Interest is payable out of the general assets of the company, including its available capital, and not merely out of profits. —*Dale* v. *Martin* (1883), 11 L.R. Ir. 371, C.A.

(*b*) The Directors of a company limited by shares may receive payment from a shareholder of any amounts remaining unpaid on his shares, and may pay out of capital interest on sums so paid up in advance of calls, either under Table A (if applicable), or under provisions to the same effect in the Articles of Association, provided they do so in good faith and in the honest exercise of the discretion confided to Directors.—*Lock* v. *Queensland Investment and Land Mortgage Co., Ltd.*, [1896] A.C. 461.

Calls paid in advance should be set out separately in the Balance Sheet. They are not share capital and should appear separately in the Balance Sheet.

In a winding-up calls in advance must be repaid before a return is made to shareholders on the amount called up.—*Re Wakefield Rolling Stock Company*, [1892] 3 Ch. 165.

They are, however, postponed to the claims of the ordinary creditors of the Company.—*Re Exchange Drapery Co.* (1888), 38 Ch.D. 171.

COMMISSION

(*a*) **Payable to Directors, Managers, Travellers, Agents, and other Employees.** Reference should be made to agreements or minutes relating to commission and a list compiled of those persons who are entitled to commission, the conditions of payment and the rate of the commission. A record should be made in the audit notebook and this should be kept up to date.

Commission may be based on net sales, or on net cash received in respect of sales (in which case no commission will be paid on sales in respect of which losses arise through bad debts), or on net profits earned or only on profits distributed as dividend. Unless the agreements or minutes are carefully worded disputes may arise as to the way in which the commission should be calculated. Disputes as to what is a sale may even arise, on the expiry of an agreement, where commission is based on sales. For example, standing timber sold but waiting to be cut and dressed might be taken partly into account in accordance with the principle of "quantum meruit."

Where the commission is based on profits *distributed* the question may arise whether profits reserved and subsequently distributed by way of bonus shares should be included, although if the profits were earned during the currency of the commission agreement it would clearly be equitable to include them.

In the absence of any agreement to the contrary commission to a Manager should be calculated on profits arrived at before charging income tax.

CASE

The Balance Sheet for one year showed a certain amount of profits, including the income tax payable by the company, and the Auditors gave a special certificate that the percentage payable to the Manager was calculated on the amount of profits less income tax.

Held (1) on the principle laid down in *Attorney-General* v. *Ashton Gas Co.*, [1904] 2 Ch. 621 (affirmed, [1906] A.C. 10), that the income tax was part of the net profits available for dividends, and that the Manager was entitled to be paid his percentage on the net profits before deduction of the tax; and (2) that, the Certificate being based on a wrong principle, the Court was not bound by it.—*Johnston* v. *Chestergate Hat Manufacturing Co. Ltd.*, [1915] 2 Ch. 338.

Presumably this decision would also apply in the case of company Directors entitled to a commission on profits.

Preliminary expenses and other capital items which have been charged to profits should, in the absence of any arrangement to the contrary, be added back to profits before calculating the

commission. The commission itself is a charge on profits and in the absence of an agreement to the contrary should be deducted in arriving at the amount on which it is calculated. If it is not intended that this course should be followed, the agreement or minute fixing the commission should make it clear. If the commission be a percentage on dividends paid, excluding dividends by way of bonus shares, any disputes on question of principle are avoided, but there may be some conflict of opinion between the other Directors and a Director entitled to commission as to the amount of dividend which should be distributed.

The legal decisions, of which particulars are given hereunder, emphasize the necessity of having expert advice when drawing up commission agreements. It is becoming a common practice to agree that the Auditor should determine the amount of the commission and that his decision should be binding on all parties. The terms should be clearly defined so that he may be in a position to give the decision.

Commission should not be deducted from sales, or from any other income in respect of which the commission has been allowed, but should be stated in the accounts either separately or grouped with other items of expenses as determined by the Directors.

The amount stated in the accounts as commission should include not only what has been actually paid, but also any sums accrued but not paid.

When an agent or traveller has received money in advance in respect of commission to be earned by him in the future, the amount so advanced should be treated as an ordinary cash advance, and the agent should be included among the debtors, or stated separately.

The Auditor should ascertain that the commission, brokerage, etc., has not been participated in by any person acting in a fiduciary capacity towards the company, unless the participator is expressly provided for in the Special Act of Parliament or in the Articles of Association relating to the company.

(*b*) **On the Underwriting or Placing of Debentures or Shares.** Section 43 of the Companies Act, 1929, continuing Section 89 of the Companies (Consolidation) Act, 1908, provides that it shall be lawful for limited companies to pay a commission in connexion with the issue of share capital. Section 44 of the 1929 Act, following the provisions of the 1908 Act, enacts that where a company has paid any sums by way of commission in respect of any shares or debentures, or allowed any sums by way of discount in respect of any debentures, the total amount so paid or allowed, or so much thereof as has not been written off, shall be stated in every Balance Sheet until the whole amount thereof has been written off. The Auditor should see that the commission paid is in

accordance with the agreement entered into and that the provisions of Section 44 are duly observed in the accounts of the company.

Section 43 deals with the payment of underwriting commission and commission on placing shares. The following conditions must be observed—

(*a*) The payment of the commission must be authorized by the Articles.

(*b*) The commission paid or agreed to be paid must not exceed 10 per cent of the issue price of the shares or such lower amount or rate as is authorized by the Articles.

(*c*) The amount or rate must be disclosed in the prospectus or statement in lieu or in any circular or notice, not being a prospectus, in which subscription of shares is invited.

Unless the foregoing conditions are fulfilled, a company may not apply its shares or capital money in payment of the above-mentioned commissions, but the restrictions of this Section would not apply to their payment out of profits, and payment in this way is lawful if the Articles so authorize.

Commission paid under Section 43 must be set out as a separate item in the Balance Sheet until completely written off and may not be included under "Preliminary Expenses."

Frequently, brokerage is paid to brokers whose clients subscribe for shares. This brokerage on placing shares is not subject to the restrictions of Section 43. The client's application form will bear the brokers' stamp, and this should be noted in vouching the payment of the brokerage.

CASES

The payment by a limited company of a reasonable amount of money to brokers by way of commission or brokerage for placing shares is not an act *ultra vires* the company.—*Metropolitan Coal Consumers' Association* v. *Scrimgeour*, [1895] 2 Q.B. 604. (In this case 2½ per cent was authorized.)

The payment of brokerage or commission to a stockbroker for placing a company's shares was in 1889 held to be an improper application of its capital, and not authorized even by a power given by the Memorandum of Association to do whatever may be "conducive to" the specified objects of the Company.—*Re Faure Electric Accumulator Co.* (1889), 40 Ch.D. 141.

This case, however, has been interpreted by the Court of Appeal to have referred to "payments of commission to brokers . . . not *bona fide* payments for work and labour done—that they were not payments in the ordinary way of business, but rather in the nature of bribes." . . . "In any case, when it is made out that the services of the broker are reasonably necessary, that the brokers are properly employed in the issue of the capital of the

company, and that the payment of a commission of so much per share is a fair and just repayment for services rendered, there is no ground, either of reason, of justice, or of principle, why the payment shall not be held to be *intra vires* and unimpeachable."—*Metropolitan Coal Consumers' Association* v. *Scrimgeour*, [1895] 2 Q.B. 609.

Section 89, Subsection (3) of the Companies (Consolidation) Act, 1908, gave a statutory sanction to this decision of the Court of Appeal, and Section 43 of the Companies Act, 1929, continues it.

In estimating the amount of the secret profit for which a promoter was accountable to a company he was held entitled to be allowed the legitimate expenses incurred by him in forming and bringing out the company, such as the reports of Surveyors, the charges of Solicitors and Brokers, and the cost of advertisements; but not a sum of money which he had expended in obtaining from another person a guarantee for the taking of shares.—*Lydney and Wigpool Iron Ore Co.* v. *Bird* (1886), 33 Ch.D. 85.

CORPORATION DUTY

This is a duty imposed by the Revenue Act, 1885, upon corporate bodies, as some compensation to the Revenue, on account of the fact that certain of their property escapes liability to probate and legacy duties. The duty is assessed at the rate of 5 per cent on the annual value, income or profits accruing to the corporation. The duty is also imposed on all unincorporated bodies, such as clubs, societies, professional bodies, etc., having a permanent succession and existence.

Certain exemptions are allowed, including *inter alia* property held for religious or charitable purposes, or for the promotion of education, literature, science, and the fine arts. Exemption is also allowed in respect of property which is held in such a manner as to be liable to legacy or succession duty. Limited liability companies and local government bodies established under Act of Parliament are not liable.

Annual Returns of the property held must be made to the Commissioners of Inland Revenue, by whom the duty is assessed and collected. Appeals may be made to the High Court.

This duty fell into desuetude for practical purposes for many years, but it has now been revived. It should not be confused with Corporation Profits Tax, which was abolished in 1924.

DEBENTURES AND BORROWED MONEYS

The Auditor should ascertain that the company has power, under its Memorandum of Association to borrow, or has an implied right to do so owing to the nature of its business. By

reference to the Articles of Association, the Auditor should ascertain the power of the Directors to exercise the borrowing powers of the company; the restrictions, if any, as to the total amount to be borrowed; and any other conditions governing the borrowing powers. The amount borrowed should be authorized by a Minute passed at a properly constituted meeting of the Directors. In the case of borrowing by debenture, the Auditor should note the conditions contained in the debenture trust deed or debentures. The conditions may provide for repayment of the debentures or loans at a premium or there may be a stipulation for a Sinking Fund to be created for the repayment of the principal, and premium on redemption, if any, and he should see that the conditions have been duly complied with, and generally speaking that the debentures have been lawfully issued.

Mortgage debentures are debentures secured by a charge, fixed or floating, on the property of the company; debentures having no such charge, that is, naked debentures, are only certificates of indebtedness.

Where debentures are being purchased out of a Sinking Fund, the Auditor should ascertain whether the conditions under which the Sinking Fund is created or the debenture issued permit of the company keeping the debentures alive for re-issue.

The total due in respect of specific mortgages on property should be stated in the Balance Sheet as a deduction from the total value of the property so mortgaged and the balance should be extended. If, however, the total of the mortgages is shown on the liabilities side of the Balance Sheet and the value of the properties on the assets side, a note should be made against the latter to the effect that they are subject to the mortgage stated on the other side of the Balance Sheet.

Where a company is buying its own debentures, the relative debentures or debenture certificates should be produced to the Auditor in the course of verifying the investments.

If the Articles of Association restrict the borrowing powers to the amount of subscribed share capital, and some of the shares have been issued as fully paid, the borrowing powers are limited to an amount equal to the share capital shares actually subscribed. Should the directors inadvertently borrow up to the amount of the issued capital where this has not all been subscribed but some issued as fully paid, it would be necessary to have the Articles amended and the loans ratified by the shareholders in general meeting.

Table "A" provides that the amount for the time being remaining undischarged of moneys borrowed or raised by the directors for the purposes of the company (otherwise than by the issue of share capital) shall not at any time exceed the issued share capital

of the Company without the sanction of the Company in general meeting.

Debenture-holders are entitled to be furnished without charge with a copy of the last Balance Sheet of the company, including every document required by law to be annexed thereto, together with a copy of the Auditor's Report on the Balance Sheet. (Companies Act, 1929, Section 136.)

Debenture-holders are creditors of the company, but the amount due to them should be kept distinct from the sums due to ordinary creditors. In a few companies they have the privilege of voting at meetings and also of having their own Auditor.

Companies sometimes issue debentures at a discount. In such cases, as the liability is to pay back to the debenture-holders the nominal amount at some future date, however remote, the nominal amount of the debentures issued must be included on the debit side of the Balance Sheet. The discount must be either written off in the period during which the debentures were issued, or, if it is not prohibited by the Memorandum and Articles of Association, the writing off may be spread over a term of years, leaving the proportion not written off as a nominal asset in the Balance Sheet.

Specific and Floating Charges on Property. A specific charge is one that, without more, fastens on ascertained and definite property, or property capable of being ascertained and defined; a floating charge is ambulatory and shifting in its nature, hovering over and, so to speak, floating with the property which it is intended to affect, until some event occurs or some act is done which causes it to settle and fasten on the subject of the charge within its reach and grasp.—*Illingworth* v. *Houldsworth*, [1904] A.C. 358.

Register of Mortgages. Every limited company, and also every company incorporated by special Act of Parliament, is obliged to keep a Register of Mortgages which specifically affect properties of the company.

This Register should contain a short description of the property mortgaged or charged, each mortgage or charge, and (except in the case of securities to bearer) the names of the mortgagees or persons entitled.

When debentures are issued to bearer it is the practice to register the name of the person to whom each debenture is first issued. When a debenture trust deed is executed it is the practice to register the Trustees or the persons entitled to the charge.

The Companies Act, 1929 (Section 79), requires registration with the Registrar of Companies of all charges covered by the section, and the instrument, if any, by which the charge is created or evidenced within twenty-one days after its creation.

A reference to the Register of Mortgages should show what

charges have been created. Where any debentures, mortgages, or other charges have been paid off, the cancelled mortgage debentures or debenture certificates should be seen by the Auditor.

CASES

No satisfactory definition of a debenture has so far been given. Chitty, J., discussed the term very fully in *Edmonds* v. *Blaina Furnaces Co.* (1887), 36 Ch.D. 215, and stated, "The term itself imports a debt, an acknowledgment of a debt, and, speaking of the numerous and various forms of instruments which have been called debentures without anyone being able to say the term is incorrectly used, I find that, generally, if not always, the instrument imports an obligation or covenant to pay. This obligation or covenant is, in most cases at the present day, accompanied by some charge or security; so that there are debentures which are secured, and debentures which are not secured."

Section 380 of the Companies Act, 1929, gives the following meaning to a debenture for the purposes of the Act—

Debenture includes debenture stock, bonds and any other securities of a company whether constituting a charge on the assets of the Company or not.

A company incorporated by Statute can borrow money only within the limits and in the manner authorized by Statute.

Where, therefore, there is no power to borrow, it is *ultra vires* to overdraw the banking account, this being in effect borrowing.—*Blackburn Building Society* v. *Cunliffe Brooks & Co.*, (1882), 22 Ch.D. 61.

If a company is authorized to borrow up to a certain amount, that means that it may not borrow beyond that amount, and it is well established that any attempt by the company to do so is *ultra vires*.—*Payne* v. *The Cork Co., Ltd*, [1900] 1 Ch. 316.

When property is conveyed by a company to trustees to secure debentures or debenture stock, and the trust deed empowers the trustees to sell any part of the property conveyed before the security is enforceable, and with the proceeds to purchase other property, which is to be held upon the like trusts, and the trustees sell part of the property, and with the proceeds of sale purchase other property which is conveyed by the vendor to them upon the trusts of the trust deed, the company not being a party to the conveyance, the conveyance is not a mortgage or charge requiring registration under this section.—*Bristol United Breweries, Ltd.* v. *Abbot*, [1908] 1 Ch. 279.

A deed by which property covered by a floating charge is subsequently made the subject of a specific charge is required to be registered.—*Cornbrook Brewery Co., Ltd.* v. *Law Debenture Corporation, Ltd.*, [1904] 1 Ch. 103.

A floating security is an equitable charge on the assets for the time being of a going concern. It attaches to the subject charged in the varying condition in which it happens to be from time to time.—*Government Stocks, etc., Co., Ltd.* v. *Manila Railway Co., Ltd.*, [1897] A.C. 86.

The Act requires registration, not of the instrument creating the charge, but of the property charged. It extends therefore to the case where there is no instrument, such as where the security is created by deposit.—*Smith's Case*, *re* South Durham Iron Co. (1879), 11 Ch.D. 579, 585.

A company incorporated under the Companies Clauses Consolidation Act, 1845, cannot, without express powers, issue bills of exchange.—*Bateman* v. *Mid-Wales Railway Co.* (1865), L.R. 1 C.P. 499.

It can, however, incur debts in the ordinary course of its business.

In October, 1904, a company raised £50,000 by 5000 £10 Income Bonds, repayable in seven years with a bonus of £25 exclusively out of the net profits from time to time of the company. By the conditions the registered holders of these bonds might exchange them for first mortgage debentures, but this was not to affect the bonus; by another condition the company had the option at any time after December, 1906, of giving notice to pay off the bonds, and six months afterwards the principal (if not converted) and the bonus were to become payable. In 1909, most of the bonds had been converted into debentures, leaving only the £25 bonus payable; no profits had been earned, but it was proposed to extinguish this £25 by the issue, in exchange for the bonus, of twenty fully paid-up new shares of the nominal value of £1 each. An action having been brought to test the validity of this proposed issue of further capital—

It was held by the Court of Appeal that there was nothing in the bond which authorized the company to turn a contingent liability on income into a present liability payable out of capital; that the proposed arrangement with the bondholders was equivalent to a payment of dividends out of capital and provided a means of issuing shares at a discount, for there was no consideration given to the company for the issue of these new shares; and that on these grounds the arrangement was *ultra vires* the company and must be restrained.—*Bury* v. *Famatina Development Corporation, Limited*, [1909] 1 Ch. 754.

There is nothing in the Companies Acts expressly or by necessary implication prohibiting a limited company from mortgaging its unpaid capital; consequently, where power to mortgage future or unpaid-up capital is given by the Memorandum of Articles of Association, a mortgage of such is valid.—*Re Pyle Works* (1890), 44 Ch.D. 534. This decision was approved by the Judicial

Committee of the Privy Council on an appeal from the Supreme Court of New South Wales, the Companies Act being for this purpose identical with our Act of 1862, on the 6th March, 1895.—*Newton* v. *Debenture-holders, etc., of Anglo-Australian, etc., Co.*, [1895] A.C. 244. The Companies Act, 1929, Section 79 (2) (*b*) implies that uncalled share capital can be mortgaged or charged.

Where moneys are advanced to secure the liability of a company under an antecedent independent guarantee, debentures giving a floating charge created by the company in favour of the guarantors, who find money to pay off the debt owing by the company and guaranteed by them, are, if the company goes into winding up within three calendar months after the issue of the debentures, invalid unless it is proved that the company was solvent immediately after the creation of the charge.

Quaere, whether it is necessary to register under this Section an agreement by a company to give a debenture containing a floating charge on its assets, where no debenture has actually been issued.—*Re Orleans Motor Co., Ltd.*, [1911] 2 Ch. 41.

The right of a creditor or member of a company to inspect the Register of Mortgages includes a right to take copies of the Register.—*Nelson* v. *Anglo American Land Mortgage Agency Co.*, [1897] 1 Ch. 130.

DEBENTURE INTEREST

The Auditor should agree the total sum paid with a schedule of the payments to the individual debenture-holders as shown by the Register of Debenture-holders, setting out the gross amount, the period covered, the rate of interest, tax deducted (unless issued free of tax), and the net amount payable. Coupons or Interest Warrants should be produced in support of the individual payments. A separate Banking Account should be opened for debenture interest, and the balance of the account agreed with the unclaimed interest as shown by an inspection of the schedule in which the individual amounts are marked off in course of comparison of the list with the coupons or warrants. If periodical payments be made inclusive of repayments of capital, as well as of payments of interest, it should be verified that the payments are correctly divided as between capital and income, for which purpose a redemption schedule should be available or be raised. Occasionally, debentures or bonds, sometimes called "Income Bonds," on which the interest is payable only *if the profits of the year* admit of payment, are issued. Whether or not interest is payable in any year on bonds of this character may be a contentious point depending on questions of depreciation, the right to create reserves and to write down capital assets of a nominal nature out of profits, and so forth. The conditions attached to

debentures or bonds of this type require, therefore, to be carefully studied.

The Auditor should see that tax at the proper rate, at present the standard rate at the date of payment, is deducted from all payments of debenture interest, and that provision is made for all interest accrued up to the date of the accounts.

Interest not claimed should not be taken to the credit of Profit and Loss Account until the claim is statute-barred, and not even then unless the Directors have decided not to recognize the claim should it subsequently be made.

CASES

In the case of a railway company incorporated by a special Act, authorizing it to issue debenture stock, bearing interest, subject to Part III (which includes Sections 22 and 27) of the Companies Clauses Act, 1863, which issued debenture stock, for which it gave certificates under its common seal, and also a warrant for interest under the signature of its Secretary, it was held that, the liability being statutory, the period of limitation was twenty years.—*Re Cornwall Minerals Railway Co.*, [1897] 2 Ch. 74.

Interest on debentures issued to raise funds for construction may be charged to capital as part of the cost of construction.—*Hinds* v. *Buenos Ayres Grand National Tramways Co., Ltd.*, [1906] 2 Ch. 654.

DEPRECIATION

An adequate provision for depreciation is a necessary charge in arriving at profits, and it should be provided for whether there are profits or not. The provision to be made should be settled in the first place by the Directors and officials of the company. The Auditor should satisfy himself that the provision made is sufficient; if he is not satisfied he should refer to the matter in his report to the members.

Depreciation arises mainly through—

(*a*) Wear and tear of assets, such as plant and machinery, which may also be superseded by new inventions and become obsolete, eventually realizing only scrap value.

(*b*) Decrease in value owing to effluxion of time of leasehold property, concessions, and patents. It sometimes happens that leasehold property improves in value during its lifetime, but even if the property be realized, the increase in the case of a company not dealing in leases is of the nature of a capital profit.

There are several methods of making provision for depreciation, of which the principal are the following—

(*a*) The fixed instalment method, whereby a given fixed percentage is written off the original cost of the asset each year,

reducing it to nil at the end of its life. This is suitable in the case of leases, patents, etc., where the length of the life is known.

(*b*) The reducing instalment method, whereby a fixed percentage is written off the reducing balance of the asset each year. Repairs and small renewals are charged to revenue. Although the depreciation charge reduces year by year, it is probable that the cost of repairs will increase as the asset gets older; for this reason the burden borne by Revenue will not vary much.

(*c*) The annuity method, whereby the asset is assumed to earn interest and a fixed amount is written off every year which, after adding interest to the asset account, will reduce the asset to nil at the end of its life.

Sometimes it is desired that the amounts set aside each year should be invested outside the business so that the cash will be available at the end of the life of the asset, when it is desired to replace it. In this case the fund accumulates at compound interest, the interest received each year being invested also, and the yearly provision is calculated on the basis that when this interest is added a sum equal to the original cost of the asset will be available for its replacement at the end of its life.

Alternatively an endowment policy may be taken out for the sum required, in which case the amount of the annual premium is charged to Revenue in lieu of depreciation and credited to a Redemption or Replacement Fund, the premiums themselves, when paid, being debited to the Policy Account.

Revaluation. Where it is not possible to estimate the likely depreciation, or the life of an asset, a revaluation should be made each year, and any diminution written off to Revenue.

For the purpose of ascertaining whether the amounts charged for depreciation as submitted to him for audit are proper, the Auditor has five points to consider—

1. The original cost of the asset.
2. The outlay, if any, of a capital nature which has since been made on the asset.
3. The estimated efficient life.
4. The estimated value at the end of the efficient life of the asset.
5. Having regard to all these points, whether the value in the books is a reasonable one.

The original cost of the asset will, in most cases, be ascertainable from the books. The Auditor should ascertain whether the asset was new when it was acquired, or whether it had been in use by any previous owner. This will affect the rate and the period of depreciation. There must also be taken into consideration whether there has been any additional outlay thereon of a capital

nature, or whether a part, or even the whole, of such outlay ought to have been charged against revenue.

The matter of depreciation may be dealt with further under the following headings—

1. Leases and similar wasting assets (see page 67).
2. Loose tools (see page 71).
3. Plant, machinery, engines, furniture and fittings (see page 71).
4. Stock (see page 81).
5. Stocks and shares (see page 80).

DIRECTORS AND THEIR REMUNERATION

The amount of the remuneration of the Directors may be fixed by the private Act incorporating the company, or by the Articles of Association, or by the shareholders by resolution at the general meeting. It is usually a fixed sum. Sometimes, however, there is payable in addition a percentage on the sales, income, gross profit or net profit; or perhaps a combination of these bases of remuneration may be adopted. If the Directors have not received the amount due to them, any amount still owing must be included as a liability in the Balance Sheet.

Where the remuneration of the Directors is either partly or entirely a percentage of the profits, whether such profits are or are not distributed by way of dividend, an Auditor must satisfy himself that provision has been made for all outstanding charges in a fair and adequate manner.

A difficult question may arise when the Directors of financial companies are entitled to a percentage on the profits, for it is not always easy to determine the profits on which the necessary calculation is to be based. The ascertainment of profits of companies of this description is referred to under PROFITS OF ISSUING HOUSES.

Where the remuneration of the Directors is left in the hands of the shareholders, to be voted at the general meeting, a statement should be made on the face of the accounts that the profit shown is subject to the amount which the shareholders may vote to the Directors for their services during the period embraced by the Accounts. Directors' fees must not be paid free of tax unless the Articles so provide or the shareholders so resolve in general meeting.

When a Managing Director or Manager of a company is paid either partly or entirely by a commission on the "net profits," the Auditor may have difficulty in satisfying himself whether the amount inserted in the accounts has been arrived at on a proper basis. The cases mentioned later show the necessity for careful consideration of the matter, and it is advisable, where there is

doubt, for a legal opinion to be obtained before the accounts are signed by either the Directors or the Auditor.

Where Directors or Managers are entitled to a commission on the net profits, failing any provision to the contrary in the Agreement, the commission itself is a charge in arriving at the net profits. The calculations are as follows, assuming the profits to be £2000 before charging the commission (x) which has been fixed at 5 per cent—

$$x = \frac{2000 - x}{20}$$

$$20x = 2000 - x$$

$$21x = 2000$$

$$x = \frac{2000}{21}$$

$$x = 95{\cdot}24$$

When the Directors receive the maximum remuneration authorized by the Articles of Association, the shareholders have no power to pass a resolution voting the Directors the payment of the income tax thereon in addition, as Articles fixing the qualification and remuneration of Directors being binding on the company as well as the Directors, the company cannot ratify an act of the Directors in contravention of such Articles without first altering them by special resolution.—*Boschoek Proprietary Co., Ltd.* v. *Fuke*, [1906] 1 Ch. 148; 75 L.J. Ch. 26.

By reference to the Articles of Association the Auditor should ascertain and agree the amount payable and see that it is duly taken into account. If the fees are paid periodically, or for broken periods, as in the case of a Director ceasing to act, he should see that the Articles express that the fees are to be *at the rate of* so much per annum, otherwise the fees are only payable for a complete year, or whatever term is fixed by the Articles.—*Re Central de Kaap Gold Mines*, [1899] W.N. 216; 69 L.J.Ch. 18; 7 Manson 82. There is usually a power in the Articles enabling the shareholders in general meeting to increase the fees.

If the Directors renounce their fees, a minute to that effect passed at a meeting at which all the Directors are present, and signed by the chairman, may suffice as evidence, but strictly speaking the renunciation ought to be under seal. When it is left to the shareholders in general meeting to fix the remuneration, the Auditor should see a minute signed by the chairman of the meeting.

In the case of a Managing Director, it should be seen that all payments are in accordance with the company's agreement with him. In whatever way the fees be fixed provision should be made

for the fees in the accounts. If no provision is made, the Auditor should draw attention to the fact in his report.

Section 128 of the Companies Act, 1929, provides that the accounts which in pursuance of the Act are to be laid before every company in general meeting shall, subject to the provisions of the Section, contain particulars of the amount paid to the Directors as remuneration for their services, inclusive of all fees, percentages, or other emoluments, paid to or receivable by them by or from the company or by or from any subsidiary company. This does not apply to a Managing Director, or to amounts paid to other Directors holding a salaried employment in the company except the amounts paid as Directors' fees. If these requirements are not complied with it is the duty of the Auditors to give the particulars in their report. "Emoluments" includes fees, percentages, and any other direct or indirect consideration and money value of any allowance or perquisites.

The assets of an incorporated company, even when a private company, are not the property of the shareholders for the time being, and if the Directors misapply those assets by applying them to purposes for which they cannot be lawfully applied by the company itself, the company, upon being properly set in motion, can make the directors liable. Directors cannot pay themselves for their services, or make presents to themselves out of the company's assets, unless authorized to do so by the instrument regulating the company, or by the shareholders at a properly convened meeting.—*Re George Newman & Co.*, [1895] 1 Ch. 674.

By an Agreement of April, 1893, a company arranged with the plaintiff to manage, develop, and realize his estates on certain terms as to remuneration, and in the course of such management employed one of its Directors, who was a Solicitor, to act professionally for the estates and paid his bill of costs, which included profit items; another Director, who was an estate agent, to manage at a salary a business connected with the estates; another Director, who was an auctioneer, to act as auctioneer on all sales of the estates at the usual commission; and gave its secretary, who was a Chartered Accountant, an additional salary for keeping the books of the estates, which were of a complex nature—

Held, that on the construction of the agreement the company were not entitled to make any charge for or in respect of the keeping of the accounts required to be kept by the company.

Held also that the Directors stood in a fiduciary relation to the company, but not to the plaintiff, and that the profit, costs, salary and commission paid to the Directors in their professional capacity might be allowed in taking the accounts between the plaintiff and the company under the Agreement.—*Bath* v. *Standard Land Co., Ltd.*, [1911] 1 Ch. 618.

By a clause in an agreement between a company and its Manager the latter was to receive a fixed salary, and also, as soon as the profits for the year had been ascertained and certified by the company's auditors, a percentage of the "net profits (if any) of the company for the whole year." The agreement provided as follows—

"For the purpose of this clause the words 'net profits' shall be taken to mean the net sum available for dividends as certified by the Auditors of the company after payment of all salaries" and other items, which did not include certain items which would be deducted before arriving at the net profits or the income tax payable by the company.

The accounts for one year showed a certain amount of profits including the income tax payable by the company, and the Auditors gave a special certificate that the percentage payable to the Manager was calculated on the amount of profits less income tax—

Held (1) on the principle laid down in *Attorney-General* v. *Ashton Gas Co.*, [1904] 2 Ch. 621 (affirmed [1906] A.C. 10), that the income tax was part of the net profits available for dividends, and that the Manager was entitled to be paid his percentage on the net profits before deduction of the tax; and (2) that, the certificate, being based on a wrong principle, the Court was not bound by it.—*Johnston* v. *Chestergate Hat Manufacturing Co., Ltd.*, [1915] 2 Ch. 338.

Under an agreement of service, made in 1914 between the defendant and the plaintiff company, the defendant became the Managing Director of the company for a term of ten years at the fixed salary of £600 per annum plus "a commission of 25 per cent, on the net profits of the business" of the company. Clause 5 of the agreement provided how these net profits were to be ascertained, and directed that from the gross profits earned by the company there should be deducted, in addition to the usual trade expenses and charges, (1) a certain percentage for depreciation of land and buildings and trade machinery and plant; (2) a sum for displacement of buildings and plant; (3) a sum for repairs and renewals; (4) the amount necessary to pay a dividend of 8 per cent on the issued share capital of the company; (5) Directors' fees; and (6) interest on loans and bank overdrafts; but that no deductions should be made for (*a*) any bonus to Directors; (*b*) life insurance premiums on the defendant's life; (*c*) income tax on profits under Schedules A and D; and (*d*) any commission or bonus paid out of profits to any employee of the company. The company made large profits for the years 1915 and 1916, in respect of which the excess profits duty under the Finance Acts was payable, and issued a summons to determine whether, in ascertaining for each year the

net profits of the business for the purpose of the Agreement of service, the excess profits duty ought or ought not to be deducted before the defendant's commission was calculated.

It was held by Neville, J., that the excess profits duty ought not to be deducted from the profits of the company before the commission of the defendant was ascertained. In his Lordship's opinion the judgment of Buckley, J. (as he then was), in *Attorney-General* v. *Ashton Gas Co.*, [1904] 2 Ch. 621, which was affirmed by the Court of Appeal (*ib.* page 626), and upheld in the House of Lords [1906], A.C. 10, was a guide in arriving at a conclusion on the matter.—*Fellows Limited* v. *Corker*, [1918] 1 Ch. 9.

By an agreement dated 30th October, 1916, the defendant was appointed works manager of the business of the plaintiff company at a salary. The company agreed also to pay him at the end of each business year of the company, and within seven days of the holding of the annual general meeting, a further sum by way of commission being a percentage upon the "net profits" for the year. There was a proviso that the certificate of the company's Auditor should be conclusive as to what constituted net profits at the end of any such business year—

Held, on construction, that "net profits" of the business for the year were the excess of the receipts for the year over the current expenses and outgoings of the same year—i.e. the fund which for that year was capable of being lawfully applied by the company to the payment of a dividend.

Held, as a matter of law, that that fund could only be arrived at after deducting excess profits duty, which was a debt of the company to the Crown.

Held, therefore that the commission ought to be calculated after deduction of excess profits duty.—*Patent Castings Syndicate Ltd.* v. *Etherington*, [1919] 2 Ch. 254.

By an agreement made in 1912 the defendant was appointed works manager of the business of the plaintiff company at a salary, and in addition he was to be paid a commission equal to £50 for every 5 per cent "profit earned by the company" (or fraction of 5 per cent *pro rata*) after 10 per cent had been earned by the company—

Held, that the words "profit earned by the company" meant profits divisible among the shareholders, in other words, "net profits," and upon the authority of the decision of the Court of Appeal in *Patent Castings Syndicate Ltd.* v. *Etherington, supra*, that in arriving at the fund upon which commission was payable excess profits duty must first be deducted.—(*Hollins & Co.* v. *Paget*, [1917] 1 Ch. 187 overruled).—*Vulcan Motor and Engineering Company* (1906) *Ltd.* v. *Hampson*, [1921] 3 K.B. 597.

A company was a private limited company with five share-

holders, all children of the original founder of the business. The defendant Directors, by virtue of their voting power, obtained the passing of a resolution, the effect of which was to increase their remuneration. The resolution provided (1) for an increase in their remuneration; (2) for payment to each of them of a sum of £260 per annum for entertaining expenses; and (3) for payment of a commission to them as additional remuneration. The plaintiff, who was a shareholder, brought an action to set aside this resolution. He maintained that the passing of the resolution was a fraudulent use of voting power by the Directors in order to appropriate to themselves funds which were the property of the company, and that it was *ultra vires* of the company, in respect (1) that the increase in remuneration of the second-named defendants under the first part of the resolution was not warranted by the financial position of the company; (2) that the so-called entertainment allowance was wholly unnecessary and unreasonable, having regard to the facts (*a*) that this allowance was not to be accounted for to the company in the same way as ordinary expenses as provided for by the Articles, and (*b*) that it was intended to be used largely by the Directors on themselves in entertainment at theatres, restaurants, and the like, and (3) that the commission payable to the second-named defendants under the third head of the resolution was excessive, considering the remuneration already received by them.

The Judge of First Instance, after hearing evidence, gave judgment for the defendants, and on appeal it was held by a majority of the Bench (1) that, applying the principle laid down by Lord Davey in *Burland* v. *Earle*, [1902] A.C. 83 the Court will not interfere with the acts of a majority of shareholders unless those acts are fraudulent in character or *ultra vires* of the company; (2) that, in the present case, the evidence did not disclose anything in the nature of fraud on the part of the defendant directors; that the resolution was confined to matters which were purely a domestic concern of the company, involving additional remuneration for services to be rendered by them and which had not been opposed by the minority shareholders other than the plaintiff; and that in consequence the resolution was not *ultra vires* of the company.—*Harris* v. *Harris Ltd., and Others* (*two Directors*), (1936), 94 *Acct.* 437.

Special notice of intention to vote remuneration to Directors must be given.—*Hutton* v. *West Cork Railway Co.* (1883), 23 Ch.D. 654.

In the absence of a contract or agreement Directors cannot claim remuneration for their services according to their value.—*Dunstan* v. *Imperial Gas Co.* (1833), 3 B. & Ad. 125.

The Articles of Association of a company provided that at the

ordinary meeting in 1906 all the Directors should retire from office. No ordinary meeting was called or held in 1906 or 1907. It was held (Sargant, J.), that all the Directors vacated office on 31st December, 1906, being the last day on which a meeting of the company for that year could have been held.—*Re Consolidated Nickel Mines, Ltd.*, [1914] 1 Ch. 883.

Under the Articles of Association of the plaintiff company the remuneration of each Director had to be fixed by the company in general meeting, but if not so fixed should be £25 per annum. In 1932, at a Directors' meeting, at which the defendant was present as a Director, it was resolved that no fees be paid, and thereafter no fees were paid or claimed until 16th October, 1934, when at a Directors' meeting it was agreed that Directors' fees of £25 for the year to 31st March, 1935, should be paid. The company in general meeting on 16th July, 1935, objected to this payment, and claimed its return. The defendant counterclaimed in respect of £25 Directors' fee for the year ended 31st March, 1934.

Held, (1) that the provision for remuneration in the Articles of Association was retrospective.

(2) That it was *ultra vires* the Directors to fix their own remuneration.

(3) That the company in general meeting was entitled to disallow any Directors' fees, and to a return of the £25.

(4) That since the Balance Sheet for 1934 had not, in accordance with Section 128 of the Companies Act, 1929, disclosed any Directors' fees and the defendant had made no previous claim, the fees must be deemed to have been waived and the counterclaim failed.—*West Hartlepool Cold Storage Co., Ltd.* v. *MacAlpine* (1936), 94 Acct. 272 (*West Hartlepool County Court*). *The Law Journal County Court Reports*, 25th January, 1936.

A clause in the Articles of Association empowering Directors on behalf of the company to "lend money" and generally undertake such other financial operations as might, in their opinion, be incidental or useful to the general business of the company, has been held to authorize a loan to a faithful and confidential servant of the company.—*Rainford* v. *James Keith & Blackman Co., Ltd.*, [1905] 2 Ch. 147.

In this case a Balance Sheet had been prepared showing a net profit of £11,493; but the Directors, with the approval of the company's Auditor, caused a supplemental Balance Sheet to be prepared, in which the net profit was increased to £176,493, by transferring £165,000 from the "Suspense" Account to the Profit and Loss Account. At a general meeting of the company both Balance Sheets were approved, and in the same year the company went into liquidation.

Ten years afterwards, the creditors having been paid, certain

Directors claimed to be paid their shares of 10 per cent of the residue of net profits, in accordance with a clause in the Articles of Association. This was opposed by the Liquidator on the ground that the value of the assets had been largely over-estimated, and that the proposed distribution of the residue could not be made without a dividend being paid out of capital.

It was however held that as it was not impossible for reasonable men, at the time when the resolutions of the general meeting were passed, to take the view then taken as to the value of the assets, the claim must be allowed, but without interest.—*Re Peruvian Guano Co., Ex parte Kemp*, [1894] 3 Ch. 690.

It was held that a director, if he acts in good faith, is entitled to rely on the officers of the company to prepare true and honest accounts. This case did not concern the Auditors, but is an interesting exposition of the legal view as to responsibilities of Directors.

The liquidator of the company sought to make the defendant liable in respect of dividends paid on the faith of Balance Sheets which included many bad debts. If the bad debts had been written off there would have been no profits.

The Lord Chancellor said—

> The charge of neglect appears to rest on the assertion that Mr. Cory, like the other Directors, did not attend to any details of business not brought before them by the general manager or the chairman, and the argument raises a serious question as to the responsibility of all persons holding positions like that of Directors—how far they are called upon to distrust and be on their guard against the possibility of fraud being committed by their subordinates of every degree. It is obvious if there is such a duty it must render anything like an intelligent devolution of labour impossible. That the letters of the Auditors were kept from him is clear. That he was assured that provision had been made for bad debts and that he believed such assurances is involved in the admission that he was guilty of no moral fraud; so that it comes to this—that he ought to have discovered a network of conspiracy and fraud by which he was surrounded, and found out that his own brother and the managing Director (who have since been made criminally responsible for frauds connected with their respective office) were inducing him to make representations as to the prospects of the concern and the dividends properly payable which have turned out to be improper and false. I cannot think that it can be expected of a Director that he should be watching either the inferior officers of the bank or verifying the calculations of the Auditors themselves. The business of life could not go on if people could not trust those who are put into a position of trust for the express purpose of attending to details of management.—(*Dovey* v. *Cory*, *National Bank of Wales Case*, [1901] A.C. 477–487; 17 T.L.R.732.)

NOTE. Some of the Lord Chancellor's remarks are not consistent with the common assumption that the accounts are the accounts of the Directors, upon which the Auditors have to report. It would appear that the liabilities of Directors are much less onerous than those imposed upon Auditors.

Directors' Qualification Shares. Sections 140 and 141 of the Companies Act, 1929, enact as follows—

140.—(1) A person shall not be capable of being appointed director of a company by the articles, and shall not be named as a director or proposed director of a company in a prospectus issued by or on behalf of the company, or as proposed director of an intended company in a prospectus issued in relation to that intended company, or in a statement in lieu of prospectus delivered to the registrar by or on behalf of a company, unless, before the registration of the articles or the publication of the prospectus, or the delivery of the statement in lieu of prospectus, as the case may be, he has by himself or by his agent authorized in writing—

(*a*) signed and delivered to the registrar of companies for registration a consent in writing to act as such director; and

(*b*) either—

(i) signed the memorandum for a number of shares not less than his qualification, if any; or

(ii) taken from the company and paid or agreed to pay for his qualification shares, if any; or

(iii) signed and delivered to the registrar for registration an undertaking in writing to take from the company and pay for his qualification shares, if any; or

(iv) made and delivered to the registrar for registration a statutory declaration to the effect that a number of shares, not less than his qualification, if any, are registered in his name.

(2) Where a person has signed and delivered as aforesaid an undertaking to take and pay for his qualification shares, he shall, as regards those shares, be in the same position as if he had signed the memorandum for that number of shares.

(3) On the application for registration of the memorandum and articles of a company the applicant shall deliver to the registrar a list of the persons who have consented to be directors of the company, and, if this list contains the name of any person who has not so consented, the applicant shall be liable to a fine not exceeding fifty pounds.

(4) This section shall not apply to—

(*a*) a company not having a share capital; or

(*b*) a private company; or

(*c*) a company which was a private company before becoming a public company; or

(*d*) a prospectus issued by or on behalf of a company after the expiration of one year from the date on which the company was entitled to commence business.

141.—(1) Without prejudice to the restrictions imposed by the last foregoing section, it shall be the duty of every director who is by the articles of the company required to hold a specified share qualification, and who is not already qualified, to obtain his qualification within two months after his appointment, or such shorter time as may be fixed by the articles.

(2) For the purpose of any provision in the articles requiring a director or manager to hold a specified share qualification, the bearer of a share warrant shall not be deemed to be the holder of the shares specified in the warrant.

(3) The office of director of a company shall be vacated if the director

does not within two months from the date of his appointment, or within such shorter time as may be fixed by the articles, obtain his qualification, or if after the expiration of the said period or shorter time he ceases at any time to hold his qualification.

(4) A person vacating office under this section shall be incapable of being re-appointed director of the company until he has obtained his qualification.

(5) If after the expiration of the said period or shorter time any unqualified person acts as a director of the company, he shall be liable to a fine not exceeding five pounds for every day between the expiration of the said period or shorter time or the day on which he ceased to be qualified, as the case may be, and the last day on which it is proved that he acted as a director.

The fact that a Director has not taken up his qualification shares does not invalidate any of the proceedings to which he has been a party, but leaves him liable to the heavy fine mentioned in Section 141. It does not appear to be the duty of an Auditor to see that the Directors are fully qualified, but it is convenient from a Director's point of view and advisable that he should do so.

CASES

In the absence of a contrary provision in the Articles a Director who is the registered holder of the required qualification shares is qualified even though he holds them merely as trustee for some other person.—*Pulbrook* v. *Richmond Consolidated Mining Co.* (1878), 9 Ch.D. 610; *Bainbridge* v. *Smith* (1889), 41 Ch.D. 462.

A liquidator of another company does not hold the shares in his own right so as to qualify him as a Director.—*Boschoek Proprietary Co. Ltd.* v. *Fuke*, [1906] 1 Ch. 148; 75 L.J. Ch. 26.

A Director is fully qualified if he is one of several joint holders of the required qualification.—*Re Glory Paper Mills, Dunster's Case*, [1894] 3 Ch. 473.

Subject to Section 140 of the Companies Act, 1929 and to the Articles of Association, qualification may be properly obtained either by taking the shares from the company or acquiring them by transfer.—*Brown's Case* (1874), 9 Ch. App. 102.

DIRECTORS' TRAVELLING EXPENSES AND OTHER OUTLAYS

The payment of Directors' travelling expenses to attend Board meetings should be authorized by the Articles of Association or by a resolution of the company; otherwise the expenses are presumed to be covered by the Directors' fees.— *Young* v. *Naval, Military and Civil Service Co-operative Society of South Africa, Ltd.*, [1905] 1 K.B. 687.

Expenses incurred in connexion with the company's business are an allowable charge.

The expense of printing and sending out proxy forms containing the names of certain of the Directors as proxies for a general meeting of shareholders, and for stamping and paying the return postage thereon, has been held to be properly payable out of the funds of the company in a case where it was the duty of the Directors to inform the shareholders of the facts governing their policy, and the reasons why they considered that this policy should be maintained and supported by the shareholders.—*Peel* v. *London and North-Western Railway Co.*, [1907] 1 Ch. 5.

The expenses of issuing proxies to procure votes, not for the interests of the company, but in the interests of the Directors personally, would probably be held not to be a proper payment out of the funds of the company.

DISCOUNTS

Provision should be made for the usual trade discount in respect of the debtors and creditors. Cash discounts granted need not be brought into account until the debts are received, nor should discount receivable be taken into account until the creditors are paid. In the case of any exceptional discounts being allowed explanations should be obtained.

DIVIDENDS—PREFERENCE AND ORDINARY

The total dividend should be agreed with the aggregate of the separate dividends paid. A schedule of the preference and ordinary shareholders made up from the Register of Shareholders at the date to which the payment of the dividend relates should be submitted to the Auditors. It should set out the gross amount, the tax deducted and net amount payable.

In the case of preference dividends and interim dividends, if the Articles so provide, the Directors may resolve to declare the dividends without reference to the shareholders. In other cases (including a final dividend) the Directors recommend the dividend to the shareholders, in whose hands the declaration of the dividend rests. They may approve the amount or resolve that a smaller dividend be paid, but they cannot resolve that a higher dividend be paid nor can they resolve that a dividend be paid where the Directors do not recommend it.—*Bond* v. *Barrow Haematite Steel Co.*, [1902] 1 Ch. 353.

The Auditor should inspect the Minute Books to verify that the necessary resolutions have been passed, and ascertain that they are in accordance with the Articles. He should verify that income tax has been deducted from the dividend, unless the dividend is payable free of tax. It is the exception for dividends to be paid free of tax in the case of preference shares. The net amount of the dividend should be transferred to a separate Banking Account for

dividends, and the balance of the Banking Account should be agreed with the dividends not claimed as shown by the schedule, the dividends paid being marked off in the schedule in course of comparison with the Dividend Warrants.

If the preference dividends are cumulative and in arrear, a note of the amount in arrear should be made on the face of the Balance Sheet as a contingent liability. Since the dividends are contingent upon profits being available to meet them and upon their declaration by the Directors, the Auditor could not, probably, insist on reference being made to arrears either on the Balance Sheet or in his report; but prudence suggests such a reference, and the information is necessary to enable shareholders to determine the position.

Ordinary Dividends. In the case of interim dividends, the Auditor should see in the Minutes that a resolution declaring the dividend has been duly passed by the Directors, and that they have power under the Articles to make the declaration. In the case of final dividends, he should see that the dividend is recommended by the Directors and the appropriate resolution passed by the shareholders in general meeting, and that it is in accordance with the Articles of Association, which will also show whether it is payable on nominal capital or paid up capital.

Note. Many Boards of Directors instruct the Auditors to check and agree all dividends and interest payments, checking the respective lists relating thereto with the Registers, and examining and initialing the Dividend Warrants before their issue.

Dividends not claimed should not be taken to credit of a Profit and Loss Account until the claim is statute-barred, and not even then unless the Directors have decided not to recognize a claim should it subsequently be made.

When the profits are not sufficiently large to admit of a dividend being paid out of them and the Directors in distributing one have recourse to the Reserve, the amount taken therefrom should not be included in the Profit and Loss Account.

When a company declares a dividend on its shares, a debt immediately becomes payable to each shareholder in respect of his dividend, for which he can sue at law, and the Statute of Limitations immediately begins to run. This, however, may not apply in the case of an interim dividend, as this is usually a decision of the directors.—*Lagunas Nitrate Co.* v. *Schroeder* (1901), 85 L.T. 22. The declaration of a dividend by the members does not make the company a trustee of the dividend for the shareholder, and an entry of the liability in the company's books —at any rate when no special part of its assets is set aside as representing the dividend and no notice of the entry is given to the shareholders—does not take the case out of the Statute. Being

payments under the Articles of Association, dividends are specialty debts, and consequently the period of limitation is twenty years.—*Re Drogheda Steam Packet Company*, [1903] Ir. R. 512. The same principle was followed in *Re Artisans' Land and Mortgage Corporation*, [1904] 1 Ch. 796.

CASES

The holders of preference shares, the dividends on which are "dependent upon the profits of the particular year only," are entitled to a dividend out of the profits of any year after setting aside a proportionate amount for depreciation, maintenance, repairs, and renewals for the year only, and are not to be deprived of that dividend in order to make good any sums which in previous years should have been set aside by the company for maintenance, but which had been improperly applied by them in paying dividends.—*Dent* v. *London Tramways Company* (1879), 16 Ch.D. 344.

When the Memorandum of Association of a company incorporated under the Companies Act, 1862, stated that a portion of the shares were to have a right of receiving a dividend by preference to the other shares, resolutions passed by the company altering the priorities and payments of the net revenue as between the preference and ordinary shareholders were held to be not valid, and that no resolution of the company, special or otherwise, could alter the contract made between the company and all the shareholders, and that the revenue of the company available for dividend must be applied in the manner originally prescribed by the Memorandum of Association.—*Ashbury* v. *Watson* (1885), 28 Ch.D. 56, and 30 Ch.D. 376.

The Memorandum of Association of a company contained this clause: "The capital of the company is £150,000, divided into 10,000 ordinary shares of £10 each, and 5000 preference shares of £10 each. The holders of preference shares shall be entitled out of the net profits of each year to a preference dividend at the rate of £10 per cent per annum on the amount for the time being paid or deemed to be paid up thereon. After payment of such preferential dividend, the holders of ordinary shares shall be entitled to a like dividend at the rate of £10 per cent per annum on the amount paid on such ordinary shares. Subject as aforesaid, the preference and ordinary shares shall rank equally for dividend." It was held that the preference shareholders were not entitled to a cumulative dividend of £10 per cent so as to have the deficiency in one year paid out of the profits of a subsequent year before paying anything to the ordinary shareholders.—*Staples* v. *Eastman Photographic Materials Co., Ltd.*, [1896] 2 Ch. 303.

The word "dividend" in its ordinary sense means the sum paid

and received, or the quotient forming the share of the divisible sum payable to the recipient.—*Lamplough* v. *Kent Waterworks Proprietors*, [1904] A.C. 27.

The Articles of a company provided for the submission of accounts up to a date within three months and reports thereon, the sanction of a dividend, and the transaction of the ordinary business at the annual general meeting. It was held by North, J., that a final dividend could not be sanctioned except at an annual general meeting, at which accounts up to the prescribed date and reports thereon were submitted.—*Nicholson* v. *Rhodesia Trading Co., Ltd.*, [1897] 1 Ch. 434.

"Profits available for dividend" mean the net profits after making any deductions which Directors can properly make before declaring a dividend.—*Fisher* v. *Black and White Publishing Co., Ltd.*, [1901] 1 Ch. 174.

A company's capital consisted of 5 per cent cumulative preference shares and ordinary shares, the preference shares having priority as to both capital and dividend, and the preferential dividend being payable before any profits could be carried to reserve.

The Articles provided that no dividends should be payable except out of profits, and that, in the event of the company being wound up, the surplus divisible assets for the time being remaining "after paying the liabilities of the company" should be applied first in repaying the preference capital and "secondly in paying the arrears (if any) of the 5 per cent preferential dividends thereon to the commencement of the winding up." The remainder of the surplus assets was to belong to the ordinary shareholders.

No dividends were ever declared, but the profits accumulated until the company was wound up—

Held, that the preference shareholders were entitled to their arrears of preferential dividends, though not declared, but only to the extent of the accumulated profits.—*Re W. J. Hall & Co., Ltd.*, [1909] 1 Ch. 521.

Re Crighton's Oil Co., [1901] 2 Ch. 184; [1902] 2 Ch. 86 Distinguished. In that case it was held that on a true construction of the Articles the preference shareholders were not entitled in a liquidation to the arrears of preference dividend inasmuch as the Directors had not declared a dividend as required by the Articles of Association.

Where a company issues preference shares carrying dividend at 10 per cent per annum, payable half-yearly, and with no words restricting the holders of such shares to the profits of the current year, the deficiency in the profits of any one year to pay the 10 per cent in full was, as between the preference and ordinary shareholder, to be made good out of subsequent profits.—*Foster* v. *Coles and M. B. Foster & Sons, Ltd.*, [1906] W.N. 107.

If the yearly profits are divisible among the holders of the ordinary shares, subject to the half-yearly dividend to the holders of the preference shares, the preference dividend is not cumulative. —*Adair* v. *Old Bushmills Distillery Co., Ltd.*, [1908] W.N. 24.

When the Directors take credit for an increase in the value of any property over the amount at which the same property stood in the preceding Balance Sheet—what is technically known as "writing-up" an asset—the Auditor, however much he may disapprove of the step from the point of view of financial prudence, has no legal power to object, provided he is satisfied it is done in a *bona fide* manner and that the fact is disclosed on the face of the accounts. It is advisable in any case to credit the amount of the writing-up to a Reserve account in the first instance even if it is proposed to set against it a debit balance on Profit and Loss Account. If the debit balance on Profit and Loss Account is written off in this way, current profits are available for the payment of a dividend.—*Ammonia Soda Co., Ltd.* v. *Chamberlain*, [1918] 1 Ch. 266.

If the appreciation in value of the property arises from excessive provision for depreciation, or otherwise, charged to Profit and Loss Account in past years, it would not be inappropriate to carry the amount to the credit of the latter account or the appropriation account, but it should be shown as a separate item.

DRAWINGS AND PATTERNS

The Auditor should scrutinize this account carefully in order to see on what basis the account is built up. The unexhausted value of such items is essentially a matter for expert opinion, and a certificate may be taken from a responsible person that the value is reasonable, though as a matter of sound finance, assets of this description should be written down as quickly as possible.

If the drawings and patterns are not written off when the expenditure is incurred, they will be capitalized, in which case a proportion should be written off each year. The item should not, however, remain in the Balance Sheet after the drawings and patterns have been superseded and are not of further use.

FOREIGN EXCHANGE

An actual realized difference in exchange can only arise where a completed exchange has been made in cash or goods, but in raising a Balance Sheet foreign moneys have to be brought in at some agreed rate, and so a difference in exchange arises. At one time it was the practice to adjust the accounts at the rate prevailing at the close of the year. Where exchanges were unstable, this led to such large differences of exchange as to obscure the true result of the trading, and the practice was adopted of converting

revenue transactions at the average rate of the trader's own remittances throughout the year or at the average rate ruling during the year.

Fixed assets are retained at the rate at which they were originally converted. Any actual gain or loss could only arise on realization, and would be a gain or loss of Capital. The floating assets should be converted at the rate ruling at the date of the Balance Sheet, though where there are wide fluctuations it may be appropriate to convert stock, stores, etc., at the average rate.

FORFEITED SHARES

When shares have been forfeited in consequence of calls due thereon not having been paid, the Auditor should read the provisions of the Articles as to forfeiture and see that the registered holders have been duly served with the notice required by the Articles of Association, or other regulations of the company, and that the necessary Minutes have been passed. After forfeiture the cash received on account of the forfeited shares should be transferred from Share Capital Account to Forfeited Shares Account and the Register of Shareholders amended.

The shares may be re-issued at a discount not exceeding the amount received from the original holders of the shares. If the discount equals the amount forfeited the share capital will be restored to the original amount as if no forfeiture had taken place. Any profit derived from the forfeiture and re-issue is available for distribution as a dividend unless the Articles provide otherwise, but it is usually carried to Reserve.

Forfeited shares may be re-issued as paid up to an amount not exceeding the amount paid by the previous holder, and may be so re-issued in consideration of a sum less than the sum credited as paid on them.—*Morrison* v. *Trustees, Executors, and Securities Insurance Corporation, Ltd.*, [1898] W.N. 154.

FORWARD CONTRACTS

Buying commodities for forward delivery is a normal and necessary feature in many businesses in order to ensure delivery at convenient dates and also to enable the manufacturer or merchant to rely on a settled price upon which to base his cost or selling prices. Transactions of this nature are not entered in the ordinary books until they mature but particulars should be recorded in a Register of Contracts. A reference should be made on the accounts that forward contracts are open. The view is, however, held that from the nature of the business it may be expected that there are open contracts at the date of the Balance Sheet, and that it is unnecessary, unless they are exceptional or if losses are anticipated and have not been provided for, to mention

them. In the ordinary way a general reference would be sufficient information. In extreme cases, where the contracts are speculative and out of the ordinary course of business, the Auditor would feel it his duty to draw attention to the contracts, but he would have to be very sure of his ground, and errors of judgment on his part might have serious consequences.

The importance of this matter receives emphasis from the recent case of the *Pepper Pool*. In this case a prospectus was issued by James and Shakespeare Ltd., an old-established business. The prospectus contained no reference to substantial and quite exceptional forward contracts. Financial disaster followed and one of the Directors was found guilty of issuing a prospectus knowing it to be false in a material particular. Two others were found guilty of aiding and abetting him. This case should be carefully studied.

FREIGHT AND CARRIAGE

If any part of the expenditure has been charged to capital, the Auditor should ascertain whether the charge is justified. Reference to the Freight and Carriage Accounts will show whether sufficient provision has been made for outstanding amounts and that any necessary apportionments have been made as between one year and another.

GOODWILL

The Auditor is only concerned to see that the amount of goodwill is correctly stated in the Balance Sheet in accordance with the facts of the case. As a general principle goodwill is based in theory on a number of years' purchase of the "super profits." Mr. A. E. Cutforth, in his book *Methods of Amalgamation*, says: "To the mind of an accountant the word 'goodwill' may, perhaps, be well described by saying that it represents the capitalized value of actual or prospective 'super earnings.' "

The idea of capitalization of "super earnings" has arisen only in comparatively recent years, but it is a sounder method in most cases than the purchase of a number of years' full profits. If a business cannot produce a higher yield of profit than a gilt-edged or first-class investment, there is little inducement to invest money in it. On the other hand, if it produces a higher yield than is normally expected from the type of business the excess over the normal yield may be regarded as "super earnings" and the consideration for goodwill may be a number of years' purchase of this excess. To ascertain it, the accounts of past years must be examined and appropriate adjustments made to allow for exceptional items and for possible variations in the future, since the purpose of the examination is to judge from the facts of the past

what may be expected in the future. The number of years selected to determine the multiplier in ascertaining goodwill must vary with the circumstances, the underlying principle being that in the result the amount of the goodwill should be the sum which a purchaser ought to pay for the opportunity of earning super profits.

The foregoing is the principle which in most cases a Professional Accountant would adopt if called upon to value goodwill, but in the case of the audit of a company or partnership the value of the goodwill has been settled and it is no part of the Auditor's duty to comment upon it.

Where a company is formed for the purpose of acquiring and carrying on an established business and takes over the assets and the liabilities, the consideration for the purchase may be money, debentures or shares (fully paid up) or partly one and partly another.

The difference between the assets acquired and the liabilities taken over, and the actual consideration is assumed to represent the goodwill of the business; it may however be quite disproportionate to the goodwill valued on the general principle referred to above. It is in fact the balance of the purchase consideration attributable to goodwill.

The real value of goodwill obviously fluctuates from year to year according to the profits earned. It would not be practicable to give effect in a Balance Sheet to the fluctuation which is in fact an unrealized accretion to or diminution of capital. Goodwill is, therefore, usually stated in the Balance Sheet at its original cost less amounts (if any) written off. As a matter of sound finance it is desirable, though not legally necessary, that goodwill be gradually written down out of profits and still more so if the business has been acquired for only a number of years.

Section 124 (2) (*c*) of the Companies Act, 1929, provides that there shall be stated under separate headings in the Balance Sheet, so far as not written off—

> "if it is shown as a separate item in or is otherwise ascertainable from the books of the company, or from any contract for the sale or purchase of any property to be acquired by the company, or from any documents in the possession of the company relating to the stamp duty payable in respect of any such contract or the conveyance of any such property, the amount of the goodwill and of any patents and trade-marks as so shown or ascertained."

CASES

There is no precise definition of the term "goodwill," it has no signification except in connexion with a continuing business. It is not easily susceptible of valuation, if susceptible at all. It is never sold apart from the business itself.—*Crutwell* v. *Lye* (1810),

17 Ves. 335; *Austen* v. *Boys* (1857), 30 L.T.O.S. 216; *Churton* v. *Douglas* (1859), 33 L.T.O.S. 57.

The goodwill of a trading company is *fixed* capital, and in ascertaining profits it is not necessary to make good any depreciation in respect of it.—*Wilmer* v. *McNamara & Co., Ltd.*, [1895] 2 Ch. 245.

INCOME TAX

The computation of liability to income tax is frequently a difficult and involved question, and in many cases it is left to the Auditor to agree the liability with the Inland Revenue Authorities. If this course is not taken and the company's officials have dealt with the matter, the official Demand Notes can be taken as evidence as to the liability. Income tax, being computed for the fiscal year ending 5th April, should, strictly speaking, be apportioned according to the date to which the accounts are made up. It is, however, a not uncommon practice to reserve for income tax on the whole of the profits for the year. While, by this method, it will not be possible to take into account variations in the rate of tax, it is sound from the financial point of view, for it ensures that the provision for income tax bears a definite relation to the profits of the corresponding period, whereas the actual assessment may be on the profits of the preceding year. It is advisable to show in the accounts how the income tax liability has been dealt with. It is frequently charged in the Appropriation Account and if the tax so charged is for a period beyond that to which the accounts relate, that fact should be made clear. For example, if the whole of the tax for the fiscal year to 5th April, 1935, is charged in the accounts for the year ended 31st December, 1934, the fact should be so stated.

The rate at which income tax should be deducted from the several classes of payments liable to deduction is dealt with in a memorandum issued annually by the Board of Inland Revenue, of which the following is a specimen—

MEMORANDUM AS TO THE DEDUCTION OF INCOME TAX FOR THE YEAR 1936–37

1. Under a Resolution of the House of Commons passed in Committee of Ways and Means on the 21st April, 1936, and having statutory effect under the Provisional Collection of Taxes Act, 1913, the standard rate of Income Tax imposed for the year commencing 6th April, 1936, is 4s. 9d. in the pound.

2. Accordingly Income Tax is deductible by reference to the rate of 4s. 9d. in the pound in respect of payments of dividends, interest, annuities, ground rents, mineral rents and royalties, copyright royalties to persons not resident in the United Kingdom, patent royalties, etc., made on or after 6th April, 1936, with the exception of—

(*a*) payments, made out of taxed sources, which became due before

6th April, 1936, from which Income Tax is deductible by reference to the rate in force at the time when the amount payable became due; and

(b) payments of feu duties, bond interest, etc., due for the period ending on 15th May, 1936, in respect of lands and heritages in Scotland assessed under Schedule A, from which Income Tax is deductible at the rate in force at the commencement of that period.

3. Attention is again drawn to the changes in the law with regard to the deduction of tax made by Section 39 of the Finance Act, 1927. Under the provisions of that Section, Income Tax is deductible from dividends, interest, annuities, ground rents and other annual payments paid out of taxed sources by reference to the standard rate for the year in which the amount payable becomes due, and not, as under the law formerly in force, be reference to an "accruing rate."

INSURANCE, INCLUDING FIRE, EMPLOYERS' LIABILITY, LIVE STOCK AND LOSS OF PROFITS

By reference to the policies and receipts the Auditor should ascertain that the premiums have been duly charged and apportioned. It is not his duty, but the Auditor may compare the amounts insured in respect of some of the assets with the corresponding values in the accounts. If there is any considerable disparity an inquiry might advantageously be made into the circumstances.

INSURANCE—NATIONAL HEALTH AND UNEMPLOYMENT

As regards National Health and Unemployment Insurance, the Auditor may, if he thinks it necessary, examine the insurance cards and see that they are stamped and that the charge for stamps corresponds with the amount in the account. These cards may be examined in conjunction with the salaries and wages books. The Auditor may also consider it advisable to test the stamping of the cards from time to time more particularly towards the close of a calendar year. Misappropriations of money drawn for stamps may occur if the cards are not stamped regularly on the due dates.

INTEREST DURING CONSTRUCTION CHARGED TO CAPITAL

The capital of a company in certain cases may be expended on the construction of a railway in a foreign country or in one of the dominions or colonies, or in the erection of a factory or other building or on some asset of a permanent character.

Parliamentary companies are usually authorized to pay interest on capital to their members during construction, and the interest is regarded as permanent Capital expenditure. Under Section 54 (1) of the Companies Act, 1929, companies are empowered to pay interest out of capital in certain cases, and to charge it to capital, provided that—

1. No such payment shall be made unless it is authorized by the Articles or by special resolution.

2. No such payment, whether authorized by the Articles or by special resolution, shall be made without the previous sanction of the Board of Trade.

3. Before sanctioning any such payment, the Board of Trade may, at the expense of the company, appoint a person to inquire and report to them as to the circumstances of the case, and may, before making the appointment, require the company to give security for the payment of the costs of the inquiry.

4. The payment shall be made only for such period as may be determined by the Board of Trade; and that period shall in no case extend beyond the close of the half-year next after the half-year during which the works or buildings have been actually completed or the plant provided.

5. The rate of interest shall in no case exceed [1] four per cent per annum, or such other rate as may for the time being be prescribed by Order in Council.

6. The payment of the interest shall not operate as a reduction of the amount paid up on the shares in respect of which it is paid.

7. The accounts of the company shall show the share capital on which, and the rate at which, interest has been paid out of capital during the period to which the accounts relate.

8. Nothing in this Section shall affect any company to which the Indian Railways Act, 1894, as amended by any subsequent enactment, applies.

Apart from this enactment, the practice of adding interest on capital to capital outlays during construction or development and treating the interest as income often obtains, as, for example, in the case of *Tea Estates*. The process, although it takes money out of one pocket as capital, and passes it into the other as income, is defensible in theory, but it is not prudent to apply the principle to undertakings of which the ultimate success is not assured, and in view of Section 54, legal advice should be taken in the case of any company which is paying interest out of capital without complying with the Section. If the Articles provide that actual cost is to be regarded as capital outlay, interest on the outlay may not be added.—*Public Works Commissioners* v. *Hills*, [1906] A.C. 368.

Interest on debentures or money borrowed for a like purpose may be so treated.—*Hinds* v. *Buenos Ayres Grand National Tramways Co., Ltd.*, [1906] 2 Ch. 654.

In the case of a construction on freehold land, depreciation should be written off, and the full maintenance and repairs charged against revenue. The rate of depreciation will probably be small and will be determined mainly by the expiration of life of the building.

CASES

In a case where a tramway company, for the purpose of converting its undertaking to a system of electric traction, issued conversion debenture stock, and the Directors passed resolutions that the interest on this stock should be treated as part of the cost of construction and charged to Capital Account during the

[1] *By Order in Council the present rate allowed is six per cent per annum.*

construction of the works, the Memorandum and Articles of Association containing no provision relating to this subject, it was held there was no general rule of law which compelled companies to charge to Revenue Account interest on moneys borrowed for the purpose of constructing works, or prohibited them from charging it during construction to Capital Account; that, in the absence of any provision to the contrary, companies were entitled to act in the same way as commercial men dealing honestly in their own business; and, therefore, that the company were at liberty to charge the interest in question to Capital Account.—*Hinds* v. *Buenos Ayres Grand National Tramways Co., Ltd.*, [1906] 2 Ch. 654.

A company incorporated by Act of Parliament, being already in possession of works constructed by means of capital raised by the issue of shares, obtained by a later Act power to raise more capital for the construction of additional works. These works were of a peculiar kind, and could not be constructed by means of contracts taken in the usual way, but required that the company should find the plant and employ workmen to act as directed by their engineer. The capital for the works was raised by the exercise of borrowing powers and by the issue of preference shares, the holders of which had certain options to convert them into ordinary shares. It was held that the company were entitled to add to the capital required for the construction of the works the amount of the interest or dividends on the loans or shares by means of which it was raised until the completion of the works.—*Bardwell* v. *Sheffield Waterworks Co.* (1872), L.R., 14 Eq. 517.

LEASEHOLD PROPERTY, CONCESSIONS, ETC.

The Ledger Balance may consist of the original cost of the lease, or cost less amount written off as depreciation. While there appears to be no legal obligation to write off the expenditure on leases, any reduction in value being regarded as a loss of Capital, sound finance demands that provision be made for depreciation, in such a manner that the lease will be written down to nil or a nominal value on its expiration. It may also be necessary to make provision for dilapidations payable at the termination of the lease and for losses in respect of any fittings or fixtures. This depreciation is not allowed as a charge for income tax purposes.

The Auditor should be satisfied that a sufficient proportion has been written off each lease and charged against the Revenue Account, so that accumulated annual provisions will reduce the amount standing at the debit of the account of each lease in the books to nil at its expiration. This statement is, however, subject to a consideration of the case of *Lee* v. *Neuchatel Asphalte Co.* (1889), 41 Ch.D. 1. (See Chapter X.)

Leasehold property may be held either as an investment or for occupation. In either case the above remarks apply. If it be an investment the rents received, after deducting the incidental expenses, such as law costs, repairs, rates, taxes, etc., should be brought in as income. If the owner occupies the leasehold premises, the amount written off in effect takes the place of rent.

The original cost can be ascertained at the first audit by reference to the Title Deeds and the Solicitor's Completion Statement. Strictly speaking the cost should be written off in accordance with leasehold tables and this more exact method is preferable in the case of leases of any length and should be recommended.

A Schedule should be prepared setting out the original cost of the lease, its date and duration, date of expiration, ground rent payable, and names of the lessors and lessees. By reference to the Schedule the Auditor will ascertain whether any leases held as security or otherwise have expired, and have the accounts amended accordingly. It may happen that the lease is of more value than either its cost or written down value even though a considerable part of the term of the lease has expired. This appreciation is of a Capital nature and in principle should not affect the provision for depreciation out of Revenue. Any appreciation of the lease is an increase of capital which, unless the Articles of Association provide otherwise, is not available for dividend purposes. Moreover, it would seem to be neither legal nor sound to take into account the capital profit of one particular item and ignore losses, ascertained or estimated, in respect of other capital items.

In partnership matters the question of the treatment of leases and capital appreciation should be determined by reference to the Articles of Partnership. If, however, they do not deal with the subject, it should be agreed by the partners. Exceptional depreciation of leases may also arise and be a justifiable charge to capital, but this is usually met by writing the lease down, either at once or gradually out of profits.

If appreciation or depreciation of the leases is considered to be of a capital nature then its division would apparently depend upon the proportion in which the partners share the capital, depreciation being charged to revenue and borne in the proportion in which the partners share profits, and capital appreciation divided according to the proportion in which the partners share capital.

CASES

The case of *Lee* v. *Neuchatel Asphalte Co.* (1889), 41 Ch.D. 1, in which the doctrine was laid down that there was nothing in the Companies Act, 1862, and subsequent Acts to prohibit a company formed to work a wasting property, as, e.g. a mine or a patent,

from distributing, as dividend, the excess of the proceeds of working above the expenses of working, nor to impose on the company any obligation to set apart a sinking fund to meet the depreciation in the value of the wasting property, has been to some extent misunderstood. The Court decided nothing more than the particular proposition that some companies with wasting assets need have no depreciation fund.—*Bond* v. *Barrow Haematite Steel Co.*, [1902] 1 Ch. 367.

Whether a company formed to work a wasting asset can so treat its expenditure in its accounts depends entirely on its Memorandum and Articles of Association. In those companies where it is permitted, if the expenses of working exceed the receipts, the accounts must not be made out so as to show an apparent profit, and so enable the company to pay a dividend out of capital, but the division of the profits without providing a sinking fund is not such a payment of dividends out of capital as is forbidden by law. In the course of his judgment in *Lee* v. *Neuchatel Asphalte Co.* (p. 136 *post*), Stirling, J., made the following remarks: "It may be that in some future year the company will have to set apart a substantial sum to represent depreciation in the value of the concession; but so long as the capital remains intact, and the current receipts exceed the current expenditure, both according to the general law and under the provisions of these particular Articles of Association, it rests entirely with the shareholders to decide whether the excess shall be divided among them or set apart as a reserve fund for replacing wasting assets, and the Court has no power to interfere with their decision, however foolish or imprudent it may seem to be."

In the Court of Appeal, Lindley, L.J., remarked: "Now we come to consider how the Companies Act is to be applied to the case of a wasting property. If a company is formed to acquire and work a property of a wasting nature, for example, a mine, a quarry, or a patent, the capital expended in acquiring the property may be regarded as sunk and gone, and if the company retains assets sufficiently to pay its debts, it appears to me that there is nothing whatever in the Act to prevent any excess of money obtained by working the property over the cost of working it from being divided amongst the shareholders, and this, in my opinion, is true, although some portion of the property itself is sold, and in some sense the capital is thereby diminished. If it is said that such a course involves payment of dividend out of capital, the answer is that the Act nowhere forbids such a payment as is here supposed."

Lopes, L.J., also remarked: "It is said by the Appellant that a company is not at liberty to pay a dividend unless they can show that their available property at the time of declaring the

dividend is equivalent to their nominal or share capital. In my opinion such a contention in untenable. Where nominal or share capital is diminished in value, not by means of any improper dealing with it by the company, but by reason of causes over which the company has no control, or by reason of its inherent nature, that diminution need not, in my opinion, be made good out of revenue. In such a case a dividend may be paid out of current annual profits, out of profits arising from the excess of ordinary receipts over expenses properly chargeable to the Revenue Account, provided there is nothing in the Articles of Association prohibiting such an application, and provided it is done honestly. It appears to me that if a contrary view were adopted it might be successfully contended that where, owing to extraneous circumstances, the capital is increased in value, that increase might be dealt with as revenue or profits, and go to increase the dividend. This is contrary to all practice, and I think contrary to principle. The capital and the revenue accounts appear to me to be distinct and separate accounts, and for the purpose of determining profits, accretions to and diminutions of the capital are to be disregarded. . . . The capital in an undertaking like this is in its inherent nature wasting. The scheme of this undertaking is that there should be a gradual exhaustion of material; the wasting is the business of the company, and without such gradual exhaustion there would be no revenue."

The decision of the Court of Appeal relieves the Auditor of responsibility in those cases where the Articles of Association are on similar lines, but it is desirable that he should point out to the Directors that to declare dividends without creating a reserve for wasting property is, in most cases, unsound finance.

LOANS BY COMPANIES

A schedule of all loans made by the company, setting out the amount of the loan, security, rate of interest, date when interest is due, and repayment of capital, should be furnished to the Auditor, the list being revised at each audit.

The Memorandum and Articles of Association should be examined in order to ascertain the power of the company to make loans and under what conditions, and what authority the Directors have to exercise such powers. The loans should be authorized by the Directors and particulars recorded in the Minutes. The documents relating to each loan, and the securities held against it, should be examined by the Auditor, who should also ascertain whether the various conditions have been complied with.

Interest received should be apportioned over the period to which it relates. If interest accrued, but not received, has been brought into account, evidence should be produced that the loan is good.

The Auditor should satisfy himself as far as possible that the securities given in respect of the loan are adequate. It is well to produce to the Directors a Schedule of the loans and to have their opinion as to the security recorded. As in the case of book debts, the Auditor should inquire into them carefully, to ascertain whether they are good.

LOOSE TOOLS

An inventory is usually made each year of the loose tools, and a valuation made and certified by a responsible official. The Ledger balance, if it exceeds the valuation, is adjusted accordingly. Sometimes no inventory is made, depreciation being written off the Ledger balances. This practice, however, is not so satisfactory, as losses and shortages are not disclosed. The Auditor should satisfy himself by inquiry that the rate of depreciation is sufficient and is what is commonly adopted in the trade.

PATENTS

Expenditure on patents which have a limited life is not an asset of a permanent character, and provision ought to be made in each year's accounts for depreciation. In settling the rate of depreciation it may be borne in mind that under certain conditions the life of the patent may be extended by an order of the Court. On the other hand, the risks of supersession must be considered, for the introduction of competitive or more up-to-date patents may render existing patents valueless before the end of their normal life. If this risk can be foreseen, it is prudent to make additional provision for depreciation. From a legal point of view it may be argued that any loss in respect of patents is a loss of capital, but as a matter of sound finance the loss should be written off out of profits. The Auditor cannot insist on this being done, but if it is not he may draw attention to the matter in his Report.

In some cases the patent may be of a greater value than its original cost but it is not usual to bring the increase into account.

PLANT AND MACHINERY, BOILERS, ENGINES, TOOLS, FURNITURE AND FITTINGS

The invoices relating to the expenditure on these items should be examined to ensure that the expenditure is a legitimate charge to capital and does not include repairs which should be charged to Revenue. Provision made for depreciation should also be carefully considered, and in conjunction with this the way in which repairs and renewals are charged. This is a matter in respect of which a responsible official of the company can be asked to advise and if necessary to give a certificate supporting his opinion. In many cases the rates of depreciation to be allowed for

income tax purposes have been settled by the Board of Referees and a Schedule of the rates agreed up to the present will be found on page 311. These rates, having been fixed after careful consideration, are some guide as to what should be written off, though in most cases prudence demands a higher rate. Depreciation may be written off the asset at the agreed rate either on the original outlay or on the diminishing figures year by year. On the other hand some business people prefer to make a reserve as they feel that in the case of claims under fire insurance policies or for other reasons a better basis is created on which to argue the question of actual values. There is probably very little in this point. The view is that where the assets are actually written down it may be used as evidence against the claimant, whereas sums carried to reserve are always open to argument.

For the purpose of arriving at the rates of depreciation the expenditure on these items should be subdivided in the books. This permits of closer comparison from year to year and enables rates to be fixed in accordance with the needs of the respective items. Rates of depreciation vary very widely in respect of tools, heavy plant, and running machinery. There is sometimes a tendency to make provision for depreciation in a rough and ready way by writing off lump sums according to the amount of profits. Depreciation must be regarded as a charge in arriving at profits and must be provided for whether there are profits or losses, since depreciation occurs whether profits are being earned or not. It is, on the other hand, true that a business is not carried on solely for

I certify as follows—

1. That the Plant, Machinery, Furniture, Fittings, etc., belonging to the company and included as assets in its Balance Sheet of .... 19... , remained in its possession during the .... ending .... 19 , and were in its possession at the latter date (minor sales of old material (if any) alone excepted), and are included as assets in the Balance Sheet at ... 19.. , in the following items:

2. That the amount expended during the .... in repairs and renewals, which has been charged to Revenue, has sufficed to keep the said plant, etc., in good order and condition, and that the amount written off for depreciation is in my opinion adequate.

3. That all amounts charged as additions to the said Plant, etc., during the .... represent real additions to capital value, as opposed to expenditure on repairs and renewals.

Signature ....

Office ....

Date ....

the purpose of writing off depreciation, and the matter should be treated with a sense of proportion.

It is always desirable that the Auditor should, where possible, go round the works and stores of a concern of which he is Auditor, and gain a first-hand knowledge of the assets representing the figures in the books.

If the Auditor thinks it advisable he may obtain from a responsible official a certificate somewhat in the form given on page 72.

Should any article of plant have been completely superseded, the Auditor should be careful to ascertain that the asset account does not include any of the cost of the original plant and machinery so superseded.

The tools used by workmen in the factory are practically always the property of their employers, and although in many concerns it is the custom for the total amount to be charged direct against the Revenue Account, in many cases credit is taken in the Balance Sheet for "Workmen's Tools." The Auditor must ascertain that full allowance has been made for wear and tear which, as a rule, is very considerable, the rate chargeable against the Revenue Account commonly varying from 25 as a minimum to 50 and even 60 per cent as a maximum. On the other hand, an annual revaluation may be preferred.

Plant and machinery are sometimes purchased under a hiring agreement, that is, an agreement in which it is provided that after the lessee has paid a rent for the use of an article for a certain number of years it shall become his absolute property on the payment of a nominal sum at the expiration of the period. Colliery wagons are frequently purchased under a five years' agreement of this description.

It is proper to capitalize a proportionate part of any payments of this nature, after charging Revenue with a fair and reasonable amount for the use of the articles acquired under the hiring agreement and providing for depreciation on the original value.

The Auditor should be satisfied that the amount included for Office Furniture is reasonable. An appropriate depreciation, calculated on the diminishing value, should be written off periodically, and charged against profits. Additions to furniture from time to time make a calculation on the original cost a matter of difficulty. Repairs should be charged to revenue.

CASE

In his judgment in an action brought under the Employers' Liability Act, 1880, Lindley, L.J., defined plant in the meaning of this Act to include "whatever apparatus is used by a business man for carrying on his business, and not his stock-in-trade, which

he buys or makes for sale; but all goods and chattels fixed or moveable, live or dead, which he keeps for permanent employment in his business."—*Yarmouth* v. *France* (1887), 19 Q.B.D. 647.

PRELIMINARY EXPENSES

I. The expenses incurred in the formation of a company, if they are not borne by the vendor, are usually charged to a "Preliminary Expenses Account." Although a capital outlay, it is usually written off over a term of years, the balance of the account appearing on the assets side of the Balance Sheet each year until finally written off.

This method of dealing with the Preliminary Expenses Account is frequently provided for in the special Act or the Memorandum and Articles of Association. In any case the preliminary expenses must, so far as they are not written off, be stated separately in the Balance Sheet (C.A. 1929, Section 124 (2)). The practice of spreading expenditure of a special or exceptional nature over a term of years is recognized in the accounts of companies. "These companies are commercial partnerships, and are, in the absence of express provisions, statutory or otherwise, subject to the same considerations."—*Griffiths* v. *Paget* (1877), 6 Ch.D. 511.

A case dealing directly with this subject is one heard in 1864, in which an action was brought by a shareholder against two Directors, the Solicitor, and one of the Auditors of a company registered under the Joint Stock Companies Act, 1856, Section 71 of which recognized the distribution of certain items of expenditure over several years, for false representations in a Balance Sheet, one of such representations being that only a portion of the "Preliminary Expenses" was brought into the year's account.

The second Auditor had resigned after the declaration of a dividend which, in his opinion, had not been earned, and he was not made a defendant. In his opinion there had been a loss, apart from any question of writing off part of the preliminary expenses, and he had concurred with the other Auditor in addressing a report to the Directors suggesting that the meeting should fix upon such sum as it might consider fairly chargeable to the Preliminary Expenses Account, and that it be written off that account at the rate of from 10 to 20 per cent per annum. While he was being examined as to the manner in which the preliminary expenses had been dealt with in the Directors' Balance Sheet, in which they had been treated on the basis that they would be written off over several years, Martin, B., observed that he remembered that the subject had been a good deal discussed as to railway companies some years previously, and there was a great objection to the course taken, "but now it appeared that there was an agreement among Auditors to spread such expenses over

a number of years; that, indeed, was objected to, and it was the reason why the North Western Railway Company were able to declare large dividends soon after they opened their line. But no doubt it was now done, and it would never do to impute it to the Directors as a fraud that they had done what was usually done by Auditors."

After these remarks by the Judge, Counsel then abandoned this part of his contention.—*Bale* v. *Cleland* (1864), 4 F. & F. 117.

II. The Auditor's first duty in dealing with this account is to ascertain by whom the expenses of forming the company have to be borne. If the agreement between the vendor and the trustee, on behalf of the proposed company, adopted by the company and embodied in the Prospectus, provides that the expenses are to be paid entirely or partly by the vendor, the Auditor should see that the company is bearing only what is in accordance with the agreement and that the amount payable has been approved by the Directors.

Where a prospectus has been issued, the Auditor should satisfy himself that the preliminary expenses do not exceed the amount mentioned therein subject to the provisions of the above-mentioned agreement. The following disbursements may be properly brought into the "Preliminary Expenses" Account as well as any other legitimate and proper expenses, connected with the formation and establishment of the company—

(1) The legal expenses for the preparation of the Memorandum and Articles of Association and the necessary agreements for the purchase of any business or property and the cost of printing,

(2) the cost of filing the necessary documents with the Registrar of Companies,

(3) the cost of all the legal work transacted on behalf of the Promoters and Directors of the company until the first allotment of shares has been made,

(4) accountancy charges,

(5) stamps and other out of pocket expenses,

(6) the legal and Parliamentary expenses for obtaining a private Act of Parliament incorporating the company, and for obtaining, if necessary, an extension,

(7) the cost of printing the private Act, Parliamentary papers, Memorandum and Articles of Association, prospectuses, notices, plans, shares and debenture certificates, etc.,

(8) the cost of printing, circulating and advertising the prospectus,

(9) the cost of printing allotment letters and share certificates, debenture certificates and debenture trust deeds,

(10) stamp duties on capital and contracts.

III. "Although a promoter of a company cannot be considered an agent or trustee for the company, the company not being in existence at the time, yet the principles of the law of agency and trusteeship are applicable to his case, and he is accountable for all moneys obtained by him from the funds of the company without the knowledge of the company."

"The fact that a promoter is acting as agent for the vendors in getting up a company for the purchase of their property does not exonerate him from accounting to the company, when formed, for any secret profit made by him.

"In estimating the amount of the secret profit for which a promoter was accountable to a company he was held entitled to be allowed the legitimate expenses incurred by him in forming and bringing out the company, such as the report of Surveyors, the charges of Solicitors and Brokers, and the cost of advertisements; but not a sum of money which he had expended in obtaining from another person a guarantee for the taking of shares."—*Lydney and Wigpool Iron Ore Co.* v. *Bird* (1886), 33 Ch.D. 85.

PREMIUMS ON SHARES

When a company carrying on a successful business requires additional capital, it may be in a position to issue the new capital at a premium.

There are many reasons why this should be done, one being that when the market value of the shares of a company is above par, the issue of new shares at less than market value of the existing shares may cause a depreciation in the value of the latter. On the other hand existing shareholders may be given the opportunity of subscribing for shares on bonus terms which preserves their rights if shares are issued at less than the market price. It would not be fair to the original shareholders, who have taken the risk of establishing the company, to allow others to come in on an equal footing after the company has proved successful. The premiums belong to the company, and although, subject to any contrary provision in the Articles, they may legally be distributed as dividend, it is not usual to take this course. It is more usual to carry the amount to reserve, and the premium may quite properly be dealt with in this way or applied towards the writing off of a nominal asset such as "Preliminary Expenses"; it is usual to write off the expenses of the issue against it. Should the Directors prefer to treat the premiums as income available for dividend purposes, the Auditor has no legal ground for objection provided that there is nothing in the Articles of Association which forbids their taking this course.

The accounts should show quite clearly how the premiums have been dealt with.

PROFESSIONAL CHARGES

The Auditor should ascertain that the bills relating to Law Costs and Accountant's charges, and those of Estate Agents, Valuers, and Patent Agents, have been approved and passed for payment by the Board of Directors or other responsible persons. If any portion of the costs or charges has been charged to capital, he should satisfy himself that the charge is justified by the facts and is correct in principle, and also that the costs and charges relate to the company's business. In the case of a company the audit fee must be fixed by the shareholders in general meeting (and must be in accordance with the Articles) except that the remuneration of an Auditor appointed before the first annual general meeting, or of an Auditor appointed to fill a casual vacancy, may be fixed by the Directors, and that the remuneration of an Auditor appointed by the Board of Trade may be fixed by the Board.

Although it is generally presumed that in the case of an appointment by the shareholders in general meeting the remuneration of the Auditor should be fixed at the time of appointment, in practice it is frequently left to the Directors to fix it according to circumstances. This is a more convenient and practical method, but if it is adopted the remuneration should be approved at the next annual general meeting.

PURCHASES

The less effective the internal control the greater is the need to compare the invoices, or a part of them, with the Purchases Day Book and also with the Stock Books.

In any case the Auditor should see that provision has been made for trade discount, and that all invoices dated forward are brought into account. Invoices filed subsequently to the date of the accounts should also be examined to ensure that they do not relate to the period under review. It is essential to verify that nothing which ought to be charged to revenue has been allocated to capital, thus swelling the profits. If, on the other hand, purchases of plant, machinery, and so forth are inadvertently charged to revenue, the error, though it should not be made, is on the safe side and, if not discovered at the time, can be rectified later, whereas it is not always easy to recover from the recipient profits which have been improperly distributed. The Auditor should be conversant with the system by which the advice notes and invoices inwards are checked prior to entry in the Purchases Book, and he may vary the checking of detail by comparing the purchases with the subsidiary records and Goods Inwards Book.

RATES AND TAXES

Ascertain that the rates refer to the property owned or occupied by the company. Cases have been known where a company has paid rates on land which did not belong to it. Ascertain also that due allowance has been granted in respect of void properties on which no rates, or reduced rates, are payable.

By reference to the demand notes or receipts see that due provision has been made for outstanding amounts, and that all necessary apportionments have been made between one year and another.

RENTS AND GROUND RENTS RECEIVABLE AND PAYABLE

A schedule or a Rent Register giving all particulars should be produced and this should be compared with the leases or rental agreements. It can then be ascertained that the receipts and payments are in accordance with the Register.

The Auditor should see that income tax has been deducted on making payment. The deduction from rents in respect of Schedule "A" tax should not exceed tax computed on the actual rent paid, and this tax should be deducted from the next instalment of rent payable to the landlord after the tax has been paid by the tenant. Income tax at the standard rate should be deducted from each payment of ground rent. In certain cases where the landlord himself pays or is assessed to income tax under Schedule "A" no deduction will be made by the tenant.

Any rents or ground rents paid in respect of a period which has not expired at the date of the accounts should be treated as a payment in advance. Any arrears should be brought into account.

If any part of the premises is sub-let, the rent received from the sub-tenant should be treated as a separate item.

It has been held that tax paid by the tenant under Schedule "A" must be deducted from the *next* payment of rent and cannot legally be deducted thereafter.—*Hill* v. *Kirshenstein*, [1920] 3 K.B. 556, C.A.

REPAIRS AND RENEWALS

The Auditor should examine carefully the records of expenditure on repairs and renewals so that he may check the amount charged to revenue under these headings. The charge will affect mainly such accounts as plant, machinery, buildings and furniture. There may be a tendency, particularly in bad years, to capitalize part or all of this expenditure by adding it to the asset account instead of charging it to revenue.

In exceptional cases where expenditure in any one year is un-

usually heavy and may properly be regarded as covering two or three years, it is permissible to carry forward a part and to write off the expenditure over an appropriate period.

ROYALTIES

The royalty agreements should be scrutinized to ensure that all royalties payable or receivable have been brought into account and have been properly calculated. Income tax should be deducted when the payment is made, whether the recipients are resident or non-resident in the United Kingdom.

SALARIES

The vouchers should be examined.

Where vouchers are not given, a list of the staff, with full particulars, certified by a responsible official, should be produced and the payments made should be in accordance with these particulars. Provision should be made for amounts accrued or accrued due. Where there are agreements with the staff, these should be examined in order to ascertain that the payments are in accordance with the agreements.

Where there is a Salaries Book this should be signed by a responsible official.

See also under COMMISSION.

SALES, CONSIGNMENTS, ETC.

Verify that the sales are all trading sales and do not include sales of plant and machinery or other capital assets; also ascertain that due provision has been made for trade discount. If goods sold but not actually delivered are included amongst the sales, ascertain that the goods have been excluded from the stock, and that the purchase price, or cost of manufacture, has been duly charged in the books, and cost of delivery reserved, if sold at a "delivered price." The Auditor should be conversant with the system by which the records of sales and deliveries of goods reach the Sales Department for entry in the books. He may usefully vary the checking of details by comparing the sales with the copy invoices and copy advice notes outwards, and by making an examination of the Goods Outwards Book.

Consignment Accounts. Consignments should be recorded in a Day Book specially ruled to record full particulars, including insurance, carriage and freight, commission, and any other charges. It is convenient that each consignment be given a distinct number in consecutive order. This number should be impressed on all documents relating to the relevant consignment. The total amount of the consignment should be debited to a Consignment Account. The Auditor can see any documents he

may require relating to the consignment at the consignor's office, or have certified copies. Eventually the consignee's accounts will be available showing the amount realized and any costs or charges deductible therefrom. The proceeds as shown by the account should be credited to the appropriate Consignment Account and debited to the consignee unless he has remitted cash in settlement. It is advisable that the profits of any one consignment should not be taken into account until the whole consignment has been disposed of. Correspondence with and accounts from the consignee will show what the position is at the date of the audit. A question will arise how the consigned stock remaining unsold should be brought into account. It may be necessary to write it down. This is a question of fact depending on the circumstances of each case.

Goods on Sale or Return (" On Appro."). These goods should be charged at cost price to an Appro. Account, or if there are many of them to separate accounts. When the goods have been sold, the Appro. Account can then be adjusted and the profit or loss carried to Profit and Loss Account. Goods out "on appro." should be brought into stock at cost price unless there has been a fall in the value of the stock, to a figure less than cost.

STOCKS AND SHARES

As to the stocks and shares comprised in the Ledger balances, a schedule should be submitted to or raised by the Auditor setting out their precise designation, the number of shares or amount of stock held, the rate of dividend (if there be a fixed dividend). Particulars should be entered as to the gross amount of the dividend actually received in the period under review, the tax deducted and net amount, the date due, the cost price or market value where ascertainable, in whose name held if there be a nominee, with spare columns in which to enter particulars as to documents produced at the verification of the existence of the investments. If the stocks or shares are charged as security, further columns should be provided in which to enter particulars showing to whom charged, the amount of the charge, the interest payable, when payable, and who holds the securities.

Where the stocks are officially quoted, a broker's certificate may be procured if deemed necessary as to the values; where not quoted, the value is a question of circumstances, involving careful inquiries and a considered judgment based on such evidence as is available in the shape of accounts, reports, or expert opinion as to the values. The Auditor should see that the dividends have all been received and accounted for, and, by reference to the counterfoils of the dividend warrants, whether they have been received gross, or less tax, or free of tax. To this extent he will at the same time be able to vouch the cash received.

Where stocks and shares have been bought and sold, see that the numbers of shares or the nominal amounts of stocks bought and sold (and not simply the money received or paid) are entered in the Ledger in respect of each transaction, and agree the number or amount of stocks and shares on hand with the difference between the purchases and sales.

Stocks and shares (especially investments of a permanent nature) are sometimes taken into the Balance Sheet at cost and sometimes at market value, if lower, but are not written up to market value if it be higher than cost. The method of valuation should be stated on the face of the Balance Sheet. In the case of financial companies dealing in stocks, the value in the accounts should be cost price or market value, whichever is lower, as in the case of trading stocks. Reserves may also be considered necessary to meet anticipated losses. In principle, profits or losses in respect of the sale of stocks or shares may be either a gain or a loss of capital or income according as the stocks or shares represent investments of capital or of accumulated profits, or are the result of a stock-jobbing business, as in the case of some financial companies. Except in the case of Trust Estates and subject in partnership matters to the conditions of the Articles of Partnership, it is desirable as a matter of sound finance that all such losses be written off out of profits at once, or over a reasonable period of years, so as to get rid of "assets" of a nominal nature. The Auditor should satisfy himself that the company has power to invest in the stocks and shares which it holds. Should the company hold partly paid shares the contingent liability in respect of uncalled capital should be disclosed on the face of the Balance Sheet. In the case of stocks and shares not producing income inquiries should be made, and reserves created, if necessary, to meet any anticipated loss.

In the case of Investment Trust Companies, where profits on the sale of investments are not made available for distribution as dividends as in the case of Finance Companies, the usual practice is to show the investments at cost and to include a note on the Balance Sheet giving the market value. Any specific reserve for depreciation of investments may be shown separately on the Balance Sheet or as a deduction from the book value of the investments.

Stocks or shares held only as security do not appear as Ledger balances.

STOCK-IN-TRADE AND MANUFACTURING STOCKS

Quantities. The Auditor does not take stock, and depends upon an examination of stock inventories and a certificate from responsible officials to the effect that the quantities have been carefully

and correctly taken; in certain cases—for example, where there are warrants for goods in warehouse—documents of title will be produced. In some industries, as an example of which cocoa companies may be instanced, a reliable statement may be available, or may be prepared, of the stock on hand at the beginning of the period, and the quantities bought and sold; the stock which should be in hand at the end of the period can thus be ascertained and a rough agreement with the Stock Sheets made after allowing for waste, shrinkage, and other variations.

In different trades the mode of procedure in taking the stock naturally varies; but the object of stock-taking is to ascertain, by number, quantity, measurement, or weight, the entire stock-in-trade, that is, the unsold portion of goods, either manufactured or purchased with the object of being resold in the ordinary course of business, and to arrive at a fair valuation on the principles laid down, which should not vary from year to year.

Value. The accepted official formula is that stocks be valued at cost or market price, whichever is the lower, and a certificate to this effect should be obtained, signed by responsible persons. Market value may mean cost to replace or selling price, if lower. Stock must not in any circumstances be valued at more than cost as the effect of such a procedure is to anticipate a profit. The formula no doubt implies that due allowance has been made for old, damaged, or depreciated goods, but it is desirable that this should be specifically stated in the certificate.

As to what constitutes true cost experts hold differing views. In one otherwise very practical treatise on the subject traders are recommended to include income tax in cost—a suggestion which pre-supposes more than a little prevision on the part of the costs clerk. Whether interest on capital should be included in cost is another debatable proposition. The Auditor should endeavour to satisfy himself that the principle adopted is reasonable and consistent from year to year. What market value implies may also be an engaging question, depending upon a variety of circumstances, sometimes simple, but more often complex. Even market quotations, where available, are not conclusive evidence, since much depends upon individual capacity in handling markets, and upon the quantities which may be put upon the market. Some stocks are not marketable except at stated seasons. To adopt the market value on a particular day in the year is not, therefore, necessarily a rational principle. The sound financial policy is that stocks be written down freely, a conservative estimate made of both cost and market value, and such reserves created as expert judgment suggests. It is sometimes possible to compare the valuation of finished stock with sales made at about the time of stocktaking, and so to obtain a key to the principle on which the

valuation has been made. A rough and ready test may be applied to stocks by working out the percentage of gross profit on sales from year to year. If the percentage be found to vary considerably, further inquiries should be made. In some trades the regular practice is to take stock at selling value less a discount, in which case the valuation may also to some extent be tested. There are also trades in which certain "base" stocks are taken at a constant value from year to year.

The valuation of stock is of vital importance, for by over-valuation the profits may be inflated or by under-valuation under-stated. It follows that the accounts of the following year would also be incorrect, since the closing stock of one year is the opening stock of the next. A case occurred in which the Manager at the end of the first year of a company's existence valued the stock at selling value. The practical effect of this was to add the whole of the difference between the cost and the selling value of the stock to sales and so show a very handsome profit, as if all the stock had been sold during the year. The second year showed a very different result and led to an inquiry which brought out the facts.

In the main, however, the Auditor, unless he specializes in a particular manufacture or trade, must depend very largely upon the certified statements of those who are engaged in the manufacture or trade and can gauge the proper valuation to be placed upon the stock. The recognized practice is for the Auditor to accept a certificate from a reliable official in a form similar to that which is now being adopted by the income tax authorities. It may be advisable that the certificate should also state that the stock has been taken on the same basis as in previous years, that all goods taken into stock have been charged as purchases, and that no plant is included, and no stock which has been charged out to customers, either as sales or on sale or return, "on appro.," or items such as cases, casks, etc., and included in book debts.

Extensions, Casts, etc. The working out and checking of the extensions and casts should be certified by those who are responsible for the work. The Auditor exercises his own discretion as to checking the whole or part of the extensions and casts.

Certificate as to Stock. A common form of certificate is given on page 84.

To obviate the delays and inconvenience of a yearly stocktaking, the quantities of stock are sometimes taken down from the Stock Ledgers at the close of the year, the actual stock being frequently compared during the year with the Stock Ledger records. The periodical comparison should be made by responsible persons and the Stock Ledger balances agreed, written down, and certified by them at reasonable intervals.

CERTIFICATE AS TO STOCK

I hereby certify that the above is a correct list of the stock as at .... 19 ... amounting in value to £ ...., that it has been taken at cost price or at market value, whichever is lower, and that due allowance has been made for old, damaged, and depreciated goods.

Quantities taken by ....

Prices and proper allowances fixed by ....

Extensions and additions made by ....

Checked by ....

Finally approved by ....

I further certify that the said stock-in-trade was the property of the company on the said date and was then in its possession, and that it includes no plant, machinery, fixtures, or fittings, or items charged to customers.

(Signed) ....
(General Manager or other responsible official.)

CASE

It is no part of an Auditor's duty to take stock. No one contends that it is. He must rely on other people for details of the stock-in-trade on hand. In the case of a cotton mill he must rely on some skilled person for the materials necessary to enable him to enter the stock-in-trade at its proper value in the Balance Sheet.—*Re Kingston Cotton Mill Company No.* 2, [1896] 2 Ch. 279.

SUBSCRIPTIONS TO TRADE SOCIETIES AND CHARITIES

These two classes of subscription should be kept distinct. In the case of companies it should be ascertained that the subscriptions are duly authorized by the Board, and as regards charities —failing power in the Memorandum of Association to make such contributions, and authority in the Articles to the Directors to exercise the power—these payments should strictly speaking be authorized or confirmed by the shareholders at the annual general meeting.

For income tax purposes it is convenient to separate those subscriptions which are allowable for income tax from those which are not, so that the information may be readily furnished to the Inspector of Taxes when the income tax computation is being made.

SUNDRY EXPENSES, including Cables, Telegrams, Heating, Lighting, Stationery and Printing, Postages and Telephones

These expenses having been duly vouched and checked with the books, it is only necessary to ascertain by a reference to the invoice files that all outstanding amounts have been brought in.

As to the telephone, lighting and heating charges, where supplied from outside sources, a reference to the demand notes or receipts will enable any necessary apportionments or reserves for outstanding amounts to be made or checked. In the case of regular charges—e.g. quarterly or half-yearly—the Auditor should see that the last account entered in the books covers the period to which the accounts relate, or that an adequate provision is made for the broken period. If the periodical account has been received prior to the completion of the audit an exact apportionment can be made.

TRADE DEBTORS

An Auditor cannot be expected to know, or even to ascertain, the financial position of the debtors, but it is part of his duty to adopt all reasonable means to see that debts not likely to be recovered are written off, or a sufficient reserve made to cover such debts as appear to be doubtful. The following methods should be adopted.

A list of the trade debtors should be submitted to the Auditor, who should ascertain which debts have subsequently been paid and on which no question should, therefore, arise. Where a debt is in arrear inquiries should be made and, if necessary, the file of correspondence with the debtor perused. Where the payments on account are irregular and not in accordance with the prescribed terms of credit, the accounts should be carefully scrutinized and reference made to the correspondence file to verify that the payments have actually been made by the debtor in question and that the revolving system is not being operated whereby moneys received from certain debtors are credited to the accounts of other debtors of older date whose payments have been misappropriated. Where debts have been written off as bad, evidence should be available in the shape of letters, or official bankruptcy or liquidation documents. If, as sometimes happens, the debts include cash sales where cash has not been promptly collected, see that the cash is accounted for and that this balance is not increasing in a disproportionate manner.

One method of procedure in respect of bad debts is to charge a percentage each year on the total amount of the debts outstanding or on the sales, thus creating a reserve to which the debts found to be bad are charged. There is no objection to this method being adopted provided the percentage is sufficiently high and adjusted when necessary in the light of experience.

The Auditor should ascertain whether the debtor is also a debtor in respect of Bills Receivable. He should examine the run of the account and note whether the debt is increasing out of proportion to the sales made to the debtor.

Some concerns issue, at the close of each year, a notice (which should be posted from the Auditor's office) addressed to each individual debtor or creditor, stating the balance due to or by them in their books. In this notice a request is made that, in the event of the balance not being agreed, a direct communication should be made to the Auditor. This is undoubtedly a most effective precaution against misappropriation.

It is necessary to ensure that adequate provision has been made for the usual trade discounts so far as not forfeited by the failure to pay within the prescribed time of credit. Cash discounts are allowed at the time of payment, and if payment is not made at the due date may be withheld. It is not usual to make provision in advance for this form of discount.

Where it is the practice to date invoices forward, care must be taken to see that the amounts are not included in the debtors and also in the stocks on hand at the date of balancing.

It should be ascertained that the individual debts are good, and that they do not include such items as payments for goods bought or for free samples, payments for services, rent, rates, taxes, law costs which ought to be written off, advances to Directors, or drawings by partners; errors of this kind sometimes arise where the book-keeper is not an expert.

When a concern employs agents to obtain business, it is desirable that the amounts which either remain in agents' hands, or have to be collected by them and accounted for, should be stated separately, and not included with "Amounts Due from Sundry Debtors."

The Auditor should be careful that commission and all other charges which have to be allowed to the agents are deducted from the balances at their debit, and charged against profits under the proper headings.

A list of the agents' balances should be prepared in the same manner as has been suggested previously for the sums due from the ordinary debtors, and those amounts which it is considered will not be ultimately realized should be treated as bad or doubtful debts.

CASES

When the Auditor, after discussion with the Manager or Secretary of a company, is not satisfied that a sufficient amount has been allowed for probable loss on realization of debts, he should, in the interests of the shareholders, bring his views before the Directors, so as to fix them with responsibility in the event of their also disagreeing with his views, as it has been held that the Directors of a banking company were not liable to the company for including in their accounts as good, debts which were, in fact,

bad, unless they could be fixed with knowledge of the fact.—*Turquand* v. *Marshall* (1876), 4 Ch.D. 376.

No balance sheet can be made out for any useful purpose without distinguishing good, bad, and doubtful debts.—*Re Frank Mills Mining Co.* (1883), 23 Ch.D. 57.

TRADE CREDITORS

It is desirable that trade creditors be set out in a separate total excluding creditors in respect of rates and taxes, rents payable, interest payable, Directors' fees, Suspense Accounts, or other items which are not strictly speaking trade creditors, and often require apportionment between one period and another. The amounts due to the trade creditors may be checked by reference to the monthly invoices or statements rendered by them. The invoices may also be checked or tested if thought fit by reference to the records of stocks and stores received. Bills payable are usually set out as a separate item in the Balance Sheet. (See BILLS PAYABLE.)

The invoices and monthly statements should be impressed with a stamp such as the following showing that they have been checked as to delivery of goods, prices, extensions and additions independently of the Cashier.

Goods received by		....
Quantities checked by		....
Prices	do.	....
Extensions	do.	....
Passed for payment		....

A certificate may be obtained by the Auditor from someone in authority that all known and ascertained liabilities have been included in the books, that no outstanding amounts have been omitted, and that all invoices dated forward have been brought into account where the goods are brought in to stock.

As a further check invoices filed and paid after the date to which the accounts are made up should be examined, so that the Auditor may ascertain that they do not relate to the period covered by the accounts.

It is a matter for consideration by the Auditor how far it is necessary to check the entry of invoices in the Purchases Book and the postings therefrom to the Bought Ledgers. He should satisfy himself that the purchases made relate to the business and that they have been duly passed for payment. The allocation of the purchases to the appropriate nominal accounts should also

be examined and, in particular, the allocation between capital and revenue. The usual periodical statements from the creditors will assist in the verification of the items in the Ledger and the balances, but they will not show the nature of the purchases, which can only be ascertained from the invoices referred to in the statements.

TRANSFER FEES

A source of revenue in nearly all companies is the fees received for the registration of the transfer of shares, usually called "Transfer Fees." In those companies whose shares are quoted in the official list of the Stock Exchange and dealt in freely, the transfer fees often form an appreciable item of revenue. The total fees should be checked by reference to the Register of Transfers. If necessary the transfer deeds themselves can be counted.

WAGES

The Auditor should verify that the wages have been properly allocated as between capital and revenue. If the Ledger shows that there is a floating balance in hand, he should see that the cash has been counted and agreed with the balance in the course of verifying the cash. If any part of the wages—for example wages spent on erection of fixed plant and machinery, or on buildings, etc.—has been capitalized, he should procure a certificate from a responsible official that the addition to capital is justified. The Auditor should also satisfy himself, so far as he can, that the expenditure is of a capital nature; he need not necessarily rely on the certificate alone. (See also VOUCHING AND VERIFYING THE CASH, Chapter V.)

WORK IN PROGRESS

This item is usually the aggregate of a number of balances representing wages paid, material purchased and used, and a percentage of establishment charges in respect of unfinished contracts. It may also include some allowance for profit considered to have been made on the completed part of the contracts and so a credit to profits. The debits for wages and material are questions of fact which can be tested and verified by reference to the invoices and wages summaries. The percentage for establishment charges may be based on the total productive wages paid or on the total hours worked at the factory or calculated by some appropriate method and charged accordingly to the work in progress. The calculation of the percentage should be carefully examined and the Auditor should satisfy himself that it is correct in principle, and inquire how far it is in accordance with the custom of the particular industry. A summary of wages paid or hours worked

and a summary of establishment charges should be produced and tested by reference to the books.

The amount of profit which may fairly be included is rather a difficult question, depending upon estimates as to the cost of completing the contracts, as to which the Auditor must rely mainly on expert advice. He should inspect the figures upon which the estimates of profits are based and satisfy himself as far as possible that they are reasonable. An inspection of past estimates and the actual results will often help him to form an opinion as to the reliability of the figures placed before him. It is advisable to adopt the policy of making conservative calculations, and even in some cases it is the practice to limit the profit to interest on capital employed, though even then it is necessary to ensure that it is not excessive.

The question, like that of stock-taking, is mainly one of expert knowledge. Certificates as to the value of the work in progress should therefore be obtained from the appropriate officials, such as the managing director, general manager, works manager, and chief costs clerk. These certificates should state that the value of the work in progress does not exceed the contract value. The Auditor will find it useful to compile for his own private use a schedule of the percentage of establishment charges as computed in various undertakings and of the basis upon which the percentages are calculated.

Stock in process of manufacture (not under contract), and subject to being sold, should be included in stock at cost, or at selling price, if lower. Receipts on account of work in progress should be traced and deducted from the work in progress.

In the case of running contracts periodical certificates are issued by the architect or engineer, recording the progress of the work and the amount payable to date to the contractor. Subject to adjustment for stocks, plant, etc., on hand and reserves for anticipated losses before completion, the profit to date will be the difference between the certified amount and the expenses incurred, including oncost as mentioned above. Where a contract is likely to cover more than one accounting period it is reasonable to take into account part, if not all, of this earned profit. Further, if this course is not adopted, the final profit or loss will be dealt with in one sum on completion, with the result that there will be considerable variations in profits as between one account and another. Some contractors carry forward the net expenditure or net credit on a contract until it is nearly—say 75 per cent or 80 per cent—completed, before taking any profit to Profit and Loss Account; but losses should in any case be provided for.

CHAPTER V

VOUCHING AND VERIFYING THE CASH

THE object of vouching is not only to test the accuracy of the receipts and payments as recorded in the Cash Book, but to prove that the receipts and payments are posted to the proper accounts, and that correct apportionments have been made. The entries should be sufficiently clear and full to enable this to be done. Where there is efficiency in the direction and management and in the general organization and book-keeping, and the vouchers and other documents are properly arranged and readily available, vouching can be carried out effectively and quickly. Where the book-keeping is defective, and the documents and vouchers are ill-arranged or missing, the Directors or partners are obviously taking a risk, and the Auditor, for his own protection and in the interests of his clients, would do well to draw their attention to the defects. Directors and partners, in their own interests and as a matter of duty, should take proper precautions against misappropriation. The discovery of irregularities by the Auditor in the course of examining the accounts after the close of the year, does not restore what has been taken. Apart from this employees should be deprived, as far as possible, of opportunities for misappropriation. If the audit is intended to prevent irregularities by employees it should take the form of a continuous, specially devised internal control. In this case appropriate remuneration should be arranged, for part of the machinery of management is being undertaken by the Auditor in addition to his ordinary functions.

CASH RECEIVED

Apart from exceptional items or special matters, receipts are generally on account of book debts or cash sales, which to some extent are indirectly vouched in the carrying out of the work already referred to in scrutinizing the Ledger balances. A comparison of cash received with the counterfoils of receipt books is idle unless a system is in operation by which the counterfoils themselves are adequately controlled. In one case of misappropriation it transpired that the cashier himself handed particulars of the receipts to the counterfoil receipts clerk, whose duty it was to make out the receipts.

Note. To control the cash received and the counterfoil receipts the manager, in opening the letters, should make a memorandum of the remittances which they contain. The cashier should be

present, and should take the remittances as well as the covering letters, afterwards handing the letters to the counterfoil receipt clerk to make out the receipts. The memorandum made by the manager should be compared by him or on his behalf with the counterfoils of the receipts, after which the counterfoils should be compared with the Cash Book, or vice versa. In this way the major part of the cash received may be effectively "vouched at the source," except in small businesses, in which the principal himself must exercise a strict control.

Other items may be vouched as follows—

Cash sales, by reference to properly controlled counterfoil receipts, or to statements of cash sales duly authenticated by the signatures of two independent persons or by a cash register. Receipts from travellers by reference to the travellers' returns, or by reference to the travellers' counterfoil receipts if they collect money, supported by a scrutiny of the customers' Ledger Accounts; dividends on bad debts by reference to official documents or correspondence; withdrawals from Deposit Account by reference to the Bank Pass Book and by agreement of the balance on deposit as certified by the bank; bills receivable by reference to the Bill Book and customers' Ledger Accounts; loans by reference to the Register of Mortgages, to the documents of loan, minutes, and correspondence; rents receivable by reference to the rent roll as settled by reference to the leases; dividends by reference to the counterfoils of the warrants, or to the securities themselves, or to the *Stock Exchange Official Intelligence*; sales of investments by reference to the brokers' contract notes; sales of property by reference to the solicitors' completion statements and agents' accounts; return of tax by reference to the claims submitted and to the official correspondence. As to banks, building societies, provident societies, and the like, see VARIOUS CLASSES OF AUDITS (Chapter XVII).

(See also preceding articles under heading SCRUTINIZING THE LEDGER BALANCES, Chapter IV.)

CASH PAID

The Auditor should ascertain what signatures are required to cheques, how the cheques are crossed, and what precautions are taken by the Directors or partners before signing them. Cheques signed by two Directors and countersigned by the secretary, or signed by partners and regularly endorsed by the payee, are prima facie evidence that a proper payment has been made, and still more so if the cheques are crossed "Account Payee only," and the name of the payee's banker added to the crossing, provided cheques are only signed by the directors, or other person empowered to draw, on the production of invoices or other state-

ments relating to the payment duly checked and passed for payment independently of the cashier. Although in many cases receipts are given on invoices, the Auditor will more frequently find receipted statements of account. It is desirable to have official forms of receipt as they provide a safeguard. In many businesses a form of receipt printed on the back of the cheque is adopted, in which case an acknowledgment is given when the cheque is endorsed. It is particularly important in these cases to examine the invoice or statement unless the payment is of such a nature that sufficient explanation may be given on the back of the cheque, e.g. salaries, rent, etc. If the invoices or other statements are entered in a columnar Invoice Day Book, the debits being posted in total to the appropriate Impersonal Accounts, the Auditor can satisfy himself as to the allocation of the amounts by examining the Invoice Day Book with the respective invoices or statements. The Invoice Day Book entries are checked to credit of accounts in the Bought Ledger, the cash payments vouched in the Cash Book and called to the Bought Ledger, and the Bought Ledger balances examined, thus making a complete check. As already mentioned, endorsed cheques should not be accepted as vouchers where receipts ought to be available, and in any case not without supporting evidence; the auditor should be satisfied that a system of internal control is carefully carried out. (See also FRAUD IN ACCOUNTS, Chapter XIV.)

The payments in the Cash Book should be numbered consecutively, and the vouchers numbered to correspond, and bound together or filed in that order, in such a way that they can be examined without loss of time in unfolding and refolding them. The vouchers, after comparison with the Cash Book entries, should be distinctly marked by the Auditor either with his initials, or preferably with a distinctive rubber stamp, so that the voucher cannot be altered and used again. The Auditor should see whether the date corresponds closely with that in the Cash Book, and that the statement is made out in the name of the client; if not he should ascertain why not. Where the voucher is also an invoice, it should be ascertained whether on the face of it the payment relates to the business.

A list of missing vouchers should be made and submitted to a responsible and independent official, who should be asked to certify that the corresponding payments are in order. Apart from stamped vouchers, evidence of payment may also be available in the shape of correspondence, agreements, or other documents, supported by endorsed cheques. Where the receipt is on the back of a cheque issued by the client, in what is now a fairly common form, it may be necessary to examine the invoices and the payee's Ledger Accounts as already mentioned, in order to see that the

payments are made against proper credits. In the case of directors' fees, auditor's charges, and other similar payments, the amount of which is readily ascertainable from independent sources, such as Articles of Association, minutes of meetings, etc., an endorsed cheque may be taken as evidence of payment, due regard being paid to the date of the cheque and the endorsement, and the total payments.

Bills payable retired should be produced. Official receipts for rates and taxes should be available, and the Auditor should take notes of the details necessary to check the apportionments. In the case of insurance premiums, the policy is the voucher for the first payment, and the renewal receipts should be produced for subsequent payments. For interest payable, a voucher should be produced showing that income tax has been deducted, except in the case of bank interest, which is checked by reference to the Bank Pass Book, and from which tax is not deducted. Where debentures are paid off, or charges redeemed, the debentures or documents should be produced, *duly cancelled*, unless, in the case of debentures, they are being kept alive for re-issue. Payments for properties should be verified by reference to the solicitors' completion statement and agents' accounts; investments by reference to the brokers' contract notes and the share certificates; applications for shares by reference to the bankers' receipts for the amounts payable on application and allotment, and calls by the bankers' receipts, or by the endorsement on the share certificate where the receipts have been exchanged for the share certificate.

WAGES (SALARIES, see page 79)

A summary of the wages sheets, supported by the wages sheets themselves, and duly certified as to the time, the rates of pay, calculations, extensions, and checking by the persons responsible and countersigned by the official who actually pays the money as well as by the works manager, is the usual form of evidence and record available to the Auditor. He may, however, check the details sufficiently to satisfy himself that the officials are carrying out their duties in a careful manner. When the hands are paid by time the time may be tested by reference to the timekeeper's records. An effective additional check is provided by a surprise wages audit, at which, by arrangement with the Directors or partners, the Auditor unexpectedly presents himself, checks everything in detail, and supervises the actual payment of the wages, accompanied by a manager who knows the hands. The Auditor may also test the wages by calling for a number of the insurance cards of the hands employed, and he should see that the cards are duly stamped and agree the stamps used with the cash paid for stamps and the stamps on hand.

PAYMENTS INTO PETTY CASH

These should be agreed as to date and amount with the entries in the Petty Cash Book; this book, in its turn, should be reasonably vouched and tested as to casting and analysis.

CUSTOMS DUTIES

No receipts are given. The payments are made either in cash or by a transfer on the Bank of England. In the latter case the returned transfers are available as evidence. The payments should, however, be substantiated by a certificate given by an independent person, stating that the amounts have been duly paid in respect of Customs Duties.

GENERALLY

A comparison of the names in the Cash Book with the names in the Bank Pass Book (or Statement) may sometimes lead to the discovery of irregularities—where, for example, the cheque is drawn in one name, but another name entered in the Cash Book.

(See also under Loans, Borrowed Moneys, Stocks and Shares, Leases, Rents and Ground Rents, Bank Charges, Salaries, Commission, Royalties, Subscriptions, Law Costs, Debenture Capital, Preliminary Expenses, Underwriting, Commission, Debenture Interest, Directors' Fees and Expenses, Dividends, Partners' Salaries and Drawings, Wages, etc.)

AGREEMENT OF CASH BOOK AND BANK PASS BOOK (OR STATEMENT) BALANCES

Each side of the Cash Book should be compared item by item with the corresponding entries in the Bank Pass Book or Statement, after which a reconciliation statement should be drawn up in the following form—

X.Y.Z. LIMITED

Statement reconciling the balance shown in the Banker's Pass Book with the Cash Book balance at 1st January, 1933.

Balance as in Pass Book				£3842	7	6
Deduct cheques drawn as under but not presented						
Dec. 22nd (name)	£81	4	2			
Dec. 26th (name)	23	1	7			
Dec. 30th (name)	6	8	4			
				110	14	1
				£3731	13	5
Add payments into Bank not cleared						
Dec. 30th (name)	£246	3	6			
Dec. 31st (name)	74	8	8			
Dec. 31st (name)	26	5	2			
				346	17	4
Balance as in Cash Book				£4078	10	9

As an additional precaution, the Auditor should request the bankers to certify to him the balance as shown by the books of the bank at the close of the year, for it is always possible for the Bank Pass Book to be tampered with before production to the Auditor, or even for a spurious book to be produced. The Auditor should write himself to the bank asking for the balances on all accounts. In this way the existence of an account of which the Auditor was unaware may be disclosed. It will probably be necessary to obtain the client's signature to the request before the bank will furnish the information. Where branches pay in locally for the credit of Head Office Banking Account, care should be exercised to see that the branch payments are not in arrear, or being used to cover up any discrepancies in paying in at the Head Office. For this purpose the branch returns should be scrutinized and the date of paying in moneys by the branches compared with the date on which they appear in the Pass Book.

Where the receipts side of the Cash Book is not compared in detail with the Bank Book, the amounts paid in should be tested here and there to ascertain that they are being paid in promptly.

CHECKING CASH IN HAND

Where, as is usual, all moneys received are paid into the Bank, and all payments other than petty cash payments made by cheque, the only cash balances in most classes of business consist of the petty cash balances and in some cases various "floats." Unless trivial in amount the cash should be counted on the last day of the year. If it is counted later, both the Cash Book and the Petty Cash Book should be written up to date, and the Cash Book compared with the Bank Book, and the respective balances agreed at the point at which the counting takes place. A more convenient practice is that the petty cash balance and the "floats" be paid into the bank on the last day of the year, and a cheque drawn to re-open the Petty Cash Account and re-establish the "floats." This avoids the counting of the money. If the petty cash balance or floats are increasing from year to year, satisfactory explanations should be obtained. Unless the cash is checked from time to time, as it should be, by the management, it is obviously better, if adopted as a matter of substituted control, that the checking by the Auditor should take place at irregular intervals.

DEPOSITS AT BANK

Deposit receipts should be produced, or a certificate from the bank, stating the amount on deposit at the date of the Balance Sheet. The interest received on the deposit should be traced in the Cash Book.

CHAPTER VI

VERIFYING THE INVESTMENTS

THE verification of investments as a part of the Auditor's duties arises to the greatest extent in the case of banks, building and friendly societies, insurance companies, discount houses, trust companies, trust estates, and similar undertakings. This is carried out by—

(*a*) The inspection of share or stock certificates in the name of the client.

(*b*) The inspection of share or stock certificates in the name of other persons or bodies, accompanied by transfers signed by them as transferors in favour of the client or in blank and undated or accompanied by a declaration of trust.

(*c*) The inspection of bearer bonds.

(*d*) The inspection of a certificate from a bank or other body or person holding the titles to the investments that they held them on a given date for account of the client, and whether or not there was a charge on them.

See later under STOCKS AND SHARES. Other securities and documents will be inspected in a similar manner, as mentioned below.

Inspection should take place as soon as possible after the close of the financial year, if not on the actual date of closing. If this is not done, the transactions after the close of the year to the actual date of inspection will have to be traced through the books.

The routine of the inspection should be carefully arranged. If the number of securities to be inspected is not large, all the documents should be produced at once and dealt with in such a way after checking that they cannot be produced again. It is desirable, if not essential, that a representative of the clients be present at the inspection and that his attention be called to any discrepancy immediately it has been found. If a representative of the clients were not present and a shortage should afterwards arise, the clients might be tempted to draw unjustified but embarrassing conclusions.

The Auditor should be furnished with a list of the securities and documents to be inspected, and the list should be checked not only with the securities and other documents but with the corresponding balances in the books.

The extent of the work, particularly in the case of banks and similar bodies, will depend on the system of internal control in force. It may be that only a test will be applied which by

comparison with the total will be quite nominal, but it is for the Auditor to satisfy himself that he has made such an examination as is in his judgment practicable, reasonable and sufficient in the circumstances of each case.

In the examination of documents production may be conveniently made in the following order, the documents likely to be parted with earliest in the course of business being inspected first; next those in respect of which time may elapse before the necessary certificates can be secured, and finally those which relate to matters of a more permanent character—

Bills of exchange and promissory notes.
Trade documents.
Temporary investments.
Stocks and shares.
Debentures, bonds, etc.
Life assurance policies, life interests and reversions.
Loans to public bodies.
Patents and trade marks.
Title deeds, including mortgages, leases, etc.

BILLS OF EXCHANGE AND PROMISSORY NOTES

In the case of banks and discount houses, the bills should be examined at the close of business on the last day of the year and agreed with the Bill Books, and agreed in total with the Ledger balance. Bills held as security for advances (usually kept in separate portfolios) should be examined in the same way. Bills remitted for collection should be verified by the subsequent receipt of the proceeds. In business houses, bills receivable will possibly have been discounted. Bills on hand should be compared with the Bills Receivable Book, and the total agreed with the balance of the Bills Receivable Account in the Ledger.

TRADE DOCUMENTS

For goods in transit, bills of lading, marine insurance policies and invoices relating to goods should be produced. For goods in warehouses, invoices, warrants to order, and fire insurance policies should be produced.

TEMPORARY INVESTMENTS

Temporary investments are generally made on account of money at short notice, or of moneys held over until a suitable permanent investment is found. The temporary investments are mainly either (1) Money on deposit at interest with a bank or with a discount company or financial house. A deposit receipt will probably be available, but in any case a certificate from the house

with which the money is deposited should be obtained; (2) Loans to stockbrokers or others on security. It is convenient that they be securities capable of transfer by delivery, such as bonds or stocks to bearer, but they may be certificates with signed transfers. The documents should be produced, and also a memorandum of deposit or an account setting out the advances.

STOCKS AND SHARES

Stocks in the United Kingdom are registered or inscribed, or to bearer, and shares are registered or to bearer.

Registered. The certificates should be examined, attention being paid to the following points—

That the certificate bears the usual note that a transfer will not be accepted by the company unless the certificate is produced.

That the certificate is in the name of the appropriate person.

Whether the shares are fully paid, and if they are not fully paid, the amount paid up, including payments in respect of calls, which are usually endorsed on the back of the certificate.

In the case of new issues it is possible that the share certificate has not yet been issued. In this case the investment will be verified by the examination of the scrip or other relative document. This may be—

(*a*) An allotment letter recording the payment of application and allotment money and having attached to it bankers' receipts for calls paid.

(*b*) An interim scrip certificate to bearer. This document is sometimes issued in exchange for the allotment letter, when all calls have been paid, pending the preparation of the definitive share certificate.

(*c*) A "Balance Receipt" where some of the shares have been sold.

(*d*) A transfer receipt where the shares have been purchased.

It is customary nowadays, in the case of a majority of share issues, to send out allotment letters which are current for a stated period. During this period the allotment may be renounced in favour of another person, or in blank. If renounced in blank, the allotment letter becomes a bearer document until the name of the person who accepts the shares is entered above the renouncer's signature. The former can then sign the form of acceptance endorsed on the letter and submit the document for registration with the company making the issue. When this is done, the shares will be registered in the name of the acceptor instead of that of the original allottee. The document must be lodged with the company by the date mentioned on it as the latest date for renunciation; if this is not done the shares will be put into the name of the original allottee and can only be transferred, by deed

or otherwise, in the ordinary way, involving the payment of the appropriate stamp duty.

Allotment letters may usually be split once during the greater part of their currency, for which purpose they must be deposited with the company and a small fee paid.

It will be seen therefore that allotment letters, either in the name of the client or in the name of another person who has renounced the shares, may be produced as evidence of a holding of shares.

Inscribed. Inscribed stocks include Consols, various Government and municipal stocks (inscribed at the Bank of England, the Crown Agents for the Colonies, or some of the principal joint stock or private banks). They are inscribed in the names of the holders in Registers kept by the inscribing houses, and a transfer can only be made by the signature in the registers of the holders attending personally, or by their attorneys. No certificates are issued, but a memorandum is issued to the holders setting out that the stocks have been inscribed in certain names. This document is often retained by the holders of the stock, and produced under the impression that it is a document of value, and is sometimes accepted as such by inexperienced Auditors. It is of no value whatsoever as a voucher, and should be disregarded. It is not surrendered on a sale of the stock. To verify inscribed stocks the first step is to fill up and submit to the inscribing banks or houses one of the official forms supplied by them for the purpose. The Auditor should enter on the form the amount and name of the inscribed stock, the person or persons in whose names it is inscribed, and the date (at the close of business) at which it should be certified as having been held. The form contains a request, addressed to the bank of inscription, to certify to the person or firm entered thereon that the stock was so held. The application must be signed by at least one of the stock-holders, and after it has been certified the form is sent direct by the bank of inscription to the person named in the application as the intended recipient (who should be the Auditor). The verification is made at each audit, a separate form being obtained and sent in each year. Where no official forms are issued, a letter is sent by the Auditor to the bank of inscription, together with an authority by the stockholders authorizing the giving of the information. In the case of certain stocks a fee of 1s. is charged for each verification, but in many cases no fee is charged. Where several stocks in the same names are entered on one form the nominal amounts should be added to a total recorded on the line below the last entry and a double line ruled underneath.

Until a few years ago it was not the practice of banks of inscription to notify, when verifying the inscription of stocks,

whether there was any charge or restraint against them, but now a statement is made as to whether or not any charge or restraint is registered against the holding.

Where an inscribed stock is being sold care must be taken to give to the bank of inscription or to the broker the address registered in the bank's books. Persons who have several addresses, or who change their addresses from time to time, may suffer delay if they do not choose the correct one in furnishing particulars. Similarly, persons who change their professions should remember how they were occupied when their particulars were furnished to the bank. To obviate this difficulty stockholders frequently adopt the description of "gentleman."

Bearer Shares. The certificates should be produced. In the case of many U.S.A. and foreign securities, the transfer of the shares is effected by an endorsement on the back of the certificate, and the document has the effect of a bearer certificate so far as title is concerned.

DEBENTURES, BONDS, ETC.

Debentures, including debentures payable to the registered holder or to bearer, or a debenture trust deed or debenture stock certificate issued under a debenture trust deed. The name of the holder and date of issue should be examined. If the debenture is redeemable, the date of redemption and the provisions for and conditions of repayment should be noted, and any repayments made traced to the Cash Book. The Auditor should see that a copy of the certificate of registration at Somerset House is printed or impressed on the documents in accordance with the Companies Act, 1929. Where there are coupons for interest attached to the debentures or bonds, the Auditor should see that they are intact, or if the coupons for the next payment of interest have been detached, that they are satisfactorily accounted for.

Not infrequently securities are in the hands of a banker, stock-broker or other person with whom it is customary to deposit securities for safe custody or temporarily. The Auditor must use his judgment as to whether he will accept a certificate from the banker or other person as evidence of the existence and custody of the documents, or whether he desires to inspect them. In most cases a certificate can be accepted without question, but in some cases the Auditor may consider it well to make a personal inspection of the securities.

LIFE ASSURANCE, REDEMPTION AND SIMILAR POLICIES, LIFE INTEREST, REVERSIONS, ETC.

See the policies of assurance, the receipts for the last premium payable, and the deed of assignment assigning the policies to the

client. As regards insurance companies, where loans have been made by the company in respect of the surrender value of policies issued by them, the policies should be produced together with the documents of loan. If all the policies are not examined, a sufficient number should be selected by the Auditor from the Register of Loans for production. As to life interests and reversions, the assignment should be seen, together with any policies taken out to cover contingencies in respect of life interests and reversions. Notice of the assignment has to be given to the respective companies, and in some cases the Auditor may deem it well to satisfy himself that notice has been given. As a rule an acknowledgment of notice will be attached to the policy.

LOANS TO MUNICIPAL CORPORATIONS, LOCAL AUTHORITIES, ETC.

The deed or certificate issued as a receipt for the principal sum should be produced. The arrangements as to repayment should be noted, and care taken that any repayments due have been accounted for.

TRADE MARKS, COPYRIGHTS, AND PATENTS

A certificate of registration should be produced for trade marks, and for copyrights. The Register of Copyrights at Stationers' Hall may also be examined. For patents the patent should be seen, also the certificate of payment of renewal fees. If acquired by assignment, the deed of assignment should be produced.

TITLE DEEDS TO PROPERTY

The "Abstract of Title" gives full particulars of all the deeds relating to property. The Auditor should take special care to see the conveyance into the names of his client by which the legal estate is vested in the client. In the absence of other evidence as to the authenticity of the deeds, on the occasion of the first audit at any rate, it is advisable to have them produced in the presence of a solicitor and verified by him. But this is a counsel of perfection and an Auditor is entitled to accept a document which on the face of it and by its endorsement appears satisfactory. Where mortgages of property are among the securities, the Auditor should see that a conveyance of the property is embodied in the mortgage, or that there is a separate conveyance. Where there is an equitable mortgage by deposit of title deeds as security, the memorandum of deposit is usually produced, also the conveyance vesting the legal estate in the borrower. A mortgage deed of later date, by which the real estate is vested in another lender, has been held by the Court to take precedence over an equitable mortgage by

deposit of the deeds. In the case of companies, even an equitable mortgage should be registered at Somerset House, pursuant to Section 79 of the Companies Act, 1929. If life assurance or redemption policies have been effected in connexion with any of the leases, they should be produced, also renewal receipts for the last premium payable. The fire insurance policies in connexion with the properties are not marketable securities, but the policies or renewal receipts are usually seen when vouching the cash. The Register of Rents may be compared with the deeds, and the various rents compared with the Cash Book. Registration of titles is compulsory in the Administrative County of London as regards freeholds and leaseholds with forty years or upwards to run. Registration of deeds is compulsory in the Middlesex Registry, and in some parts of Yorkshire. The Land Certificate issued by the Land Registry constitutes a possessory title, and consequently the conveyance into the name of the purchaser referred to above is not necessary.

COPYHOLDS

This form of tenure has now been abolished.

SHIPS AND MORTGAGES ON SHIPS

The register at the Port of Registry should be inspected to see that the ship is duly registered and to ascertain that the mortgages appear on the register and that no other mortgages or charges ranking in priority have been registered. (See also SHIPPING ACCOUNTS, page 249.)

CHAPTER VII

THE JOURNAL

THE Journal in its original form, in which the fundamental principle of double-entry that every debit must have a credit, was clearly brought out, is not now in use in England to so great an extent as formerly.

In most countries on the Continent the use of the Journal, which is governed by the Code Napoleon, is compulsory; no entry may be made until each folio has been numbered and signed by the appointed official, Judge of the Tribunal of Commerce, Magistrate in the domicile of the trader, or whoever it may be. On the last page of the Journal a certificate is inserted of the number of folios making up the book.

These formalities do not imply that the contents of the Journal are correct; frequently it is not so. The main purpose is to prevent substitution of books, in case there should at any time be legal proceedings, or should bankruptcy ensue. A complete and well-kept Journal in the continental form sets out conveniently the summarized transactions of the business, and from this point of view is extremely useful to the Auditor; as it is common form it can be readily followed.

In England the use of the Journal has been reduced to a minimum in most businesses, and instead subsidiary books, such as Sales Day Books, Purchases Day Books, Returns Books, which are in fact Journals designed specially for the record of transactions of one class, are used. The advantages of such a subdivision are obvious, the chief being—

(1) All entries in each book are of the same kind.

(2) Analysis can conveniently be made in appropriate columns.

(3) Periodical totals can be made—weekly, monthly, etc., as desired—so giving a periodical total of sales, purchases, returns, etc.

(4) Periodical totals can be posted to the Ledger, instead of separate items, as in the case of the standard two-column Journal.

(5) Explanatory narrative is reduced to a minimum, since the general nature of the items is clear from the form and title of the book.

(6) Total accounts are more easily extracted and sectional or total balancing effected.

As a result of this dissection, the Journal is now used sparingly, and as a rule the entries are frequently limited to adjustments,

opening entries of a new business or company, transfers and closing entries, for which no special book is provided—though where transfers are numerous a special Transfer Journal may even be used. The narrative of a Journal entry, if carefully and fully worded, can be very helpful to the Auditor. The practice of making transfers from one Ledger account to another, without the intervention of the Journal, should be discouraged by the Auditor. There was a time when this practice was cited as one of the cardinal sins of book-keeping. Entries of this kind may be clear to the mind of the book-keeper at the time of record, but later his recollection may be blurred and in the inevitable absence of narrative he will be quite unable to explain why he made them. Some book-keepers consider that the transfer of balances at the end of the year to the Profit and Loss Account or elsewhere may safely be made direct in the Ledger, without danger of misunderstanding, and this may be conceded. The ability to make a Journal entry which gives an intelligible record is the mark of a sound book-keeper who knows his work.

The vouching of the Journal is usually very important, supporting data being examined by the Auditor, in respect of the separate entries. Where several items make up an entry the additions should be checked to verify that the debits equal the credits. Postings should be checked to the various Ledgers. Supporting data will take many forms such as contracts, minutes, correspondence, and, in the case of closing entries, the Ledger accounts. The opening entries for the share capital of a company will be made from application and allotment books, records of calls, and similar particulars. The entries are in many cases so much dependent upon the nature of the business that it is not possible to give comprehensive guidance to the requirements of the Auditor in every case.

CHAPTER VIII

CAPITAL AND INCOME

One of the important duties of an Auditor is to satisfy himself that capital and income are properly distinguished in the accounts, and more particularly that nothing is charged to capital which ought to be charged to income, thus improperly adding to the income available for distribution. All additions to capital should, therefore, be carefully vouched and when necessary the allocation certified by a responsible official. From a financial point of view, sound practice requires that only those outlays which are directly productive and increase the earning capacity should be permanently capitalized, and that other forms of capital outlay, such as preliminary expenses, alterations to premises, fines on renewal of a lease, and such-like, should be written off as quickly as may be, and in addition to the provision made for depreciation of wasting assets. If possible, any losses of capital should also be written off out of profits over a term of years. This is the conservative practice instinctively adopted in partnerships and in soundly managed companies, and it is one with which the Auditor will naturally concur.

In theory all capital expenditure should be met out of capital, additional capital being raised when necessary to meet additional capital expenditure. This principle is clearly set out in what is known as the double account system which is applied to certain statutory companies, the object being to show separately in an account the amount of capital issued and its disbursement (see Chapter XVII, page 246). In commercial undertakings this method is not followed. Losses in respect of trading are on a different footing. On a strictly legal view they need not be made good out of profits in subsequent years before dividends are paid, but may be left, so to speak, "in the air" (*Ammonia Soda Co., Ltd.* v. *Chamberlain*, [1918] 1 Ch. 266). In practice this legal principle is not followed. It is impracticable and inconvenient, financially unsound, and open to abuse. For example, if accounts were taken monthly, quarterly or half-yearly, the same principle would seem to apply. To comply with the legal theory additional capital would have to be raised in one form or another to replace the money lost in trading, otherwise insolvency would follow. In the Ammonia Soda case, Warrington, L.J., in the course of his Judgment in the Court of Appeal said: "I am, of course, far from saying that in all such cases dividends can properly be paid without making good the previous loss; the nature of the business

and the amount of the loss may be such that no honest and reasonable man of business would think of paying dividends without providing for it."

The usual practice where losses have accumulated but the undertaking is considered capable of earning profits under efficient management, is to reconstruct the company and reduce the share capital so that past losses may be written off.

Although the distribution of profits up to the hilt might not be open to objection in law, it is the custom in practice to put a proportion to reserve or to carry it forward to subsequent years. It is then either used in the business as working capital, or invested. It follows that although the original share capital remains the same, undivided profits are being used as a form of capital, which does not carry interest or participate in dividends. The effect is to make the percentage of dividends calculated on the nominal capital higher, and it may therefore be misleading for statistical purposes. This practice of making reserves and restricting dividends arises out of the business instinct to build up a strong financial position. This was in fact the policy adopted by traders in pre-company days when they drew out of profits what they needed for their personal requirements and, out of profits, wrote down all the assets to a nominal figure, investing the surplus cash which inevitably arose out of their drastic methods of finance. A limited company cannot in fairness to its shareholders go to such extremes, but experience shows that sound companies have always adopted this policy to a reasonable extent and so built up a strong liquid position. As long as the matter is made clear in the accounts, the Auditor will welcome these conservative financial methods.

Where, however, the interests of capital and income may conflict, as for example in the case of life-owner and remainder-man, persons sharing in profits under agreements of various types, preference and ordinary shareholders, or retiring partners, financial considerations have to give way, and the accounts should be drawn up in strict accordance with the legal rights of the respective parties. In such cases the testator's Will, the agreements or Articles of Association, as the case may be, should be carefully studied, and it may often be necessary to procure legal advice before settling the accounts. The leading legal cases bearing on the question of capital and income should be read. (See TRUST ACCOUNTS, Chapter XV, page 199.) Many income tax cases also indicate the judicial view as to the distinction between capital and income. A full report of the case *The Ammonia Soda Co., Ltd.* v. *Chamberlain*, [1918] 1 Ch. 266 mentioned above, should be carefully studied. This case reaffirmed the legal principle that, subject always to the contents of the Articles of

Association of any particular company, the profits earned in any one year may be distributed as dividend without providing for losses sustained in previous years, or, to put it in another way, although there be "a debit to Profit and Loss Account." The principle is, however, a dangerous one in practice, as Warrington, L.J., indicated in his Judgment, and is obviously open to manipulation and abuse.

It seems clear that if profits are paid away, although a debit to Profit and Loss Account is being carried forward, cash representing capital is being entrenched upon to provide the dividend. In such a case, should it arise, the duty of the Auditor is to see that the facts are fully disclosed to the shareholders, as in fact they were in the case referred to. As mentioned under "Reserves," it has been suggested, on the strength of this case, that capital assets may be written up on a revaluation, the increase carried to a reserve, and the reserve divided in the shape of bonus shares. A study of the case does not bear out this suggestion, for the decision turned on the principle already mentioned, that previous losses need not be made good out of subsequent profits before paying a dividend. In any case, an addition to the valuation of what is already the company's property does not seem to be good consideration for an allotment of shares. The following cases should also be read: *Lee* v. *Neuchatel Asphalte Co.* (1889), 41, Ch.D. 1; *Verner* v. *General & Commercial Investment Trust*, [1894] 2 Ch. 239; *Re National Bank of Wales, Cory's case*, [1899] 2 Ch. 629, which went to the House of Lords as *Dovey* v. *Cory*, [1901] A.C. 477; 17 T.L.R. 732.

CHAPTER IX

REVENUE AND EXPENDITURE, INCOME AND EXPENDITURE, TRADING AND PROFIT AND LOSS ACCOUNTS, AND THE BALANCE SHEET AND AUDITOR'S REPORT

THE Ledger balances extracted from the Trade Ledgers, the Impersonal and Private Ledgers, having been checked or tested and scrutinized as set out in Chapter IV, the Auditor is now in a position to consider the Balance Sheet (raised from the Ledger balances) to which his report has to be appended, and the relative accounts, which should be as follows—

Manufacturing or Trading Concerns
Manufacturing Account, Trading Account and Profit and Loss Accounts.

Trusts, Professions, Charities, Colleges, Schools, and similar bodies
An Income and Expenditure Account, or a Receipts and Payments Account.

Insurance Companies and Railway Companies
As prescribed by Law, see Chapter XVII.

Hospitals
As laid down in the Revised Uniform System of Hospital Accounts.

States and Public Bodies
A Revenue Account, see Chapter XVII.

Parliamentary Companies
As laid down by the Act of Parliament under which they are incorporated.

These distinctive headings are not always observed in practice but the Auditor, as an expert, should see that they are observed, unless in the case of a limited company the Articles of Association prescribe otherwise.

MANUFACTURING ACCOUNT

This account is raised in order to show the total cost of manufacture which is carried to the debit of the Trading Account.

For example, a brewery undertaking would raise a Brewing Account showing the cost of the beer, a Beer Account showing the gross profit on sales, and a Profit and Loss Account, showing the net profit, after bringing in rents, received and paid.

MANUFACTURING ACCOUNT, 31ST DECEMBER, 193.

Dr.	*Cr.*
To Raw Material	By Trading Account
,, Coal and Coke	
,, Power	
,, Dyes	
,, Tin and Sundries	
,, Wages	
,, Depreciation	
,, Rates and Water	
,, Salaries	
,, Stores	
,, Repairs to Plant	

TRADING ACCOUNT

This account is raised to show the gross profit or loss on trading for the period reviewed. This should be the difference between the amount of stock on hand at the commencement of the period added to the purchases, wages, and other expenses incidental to production, and the sales and the stock on hand at the end. The opening stock purchases and expenses are shown on the debit side and the sales and closing stock on the credit side. An excess on the credit side over the debit side of the account is a gross profit. An excess on the debit side is a loss. The balance, whether a profit or a loss, is carried to the Profit and Loss Account. The expenses which relate directly to purchasing and manufacture and the expenses which relate directly to sales (except carriage outwards) should be shown separately in the trading account.

TRADING ACCOUNT

Year Ended 31st December, 193.

Dr.	*Cr.*
To Stock 1st January, 193.	By Sales
,, Manufacturing Account	,, Stock 31st December, 193.
,, Packing	
,, Carriage	
,, Freight and Duty	
,, Rates, Water, etc.	
,, Non-Productive Wages	
,, Balance being Gross Profit carried to Profit and Loss Account	

Sometimes, for the purpose of more exact costing the Manutacturing and Trading Account is charged with interest upon the capital invested in the buildings, plant and machinery, and also upon the stock held from time to time and with appropriate depreciation. Except for the purpose of costing, interest should not be added to stock and so added to profits unless the stock will bear it, but see WINE AND SPIRIT MERCHANTS' ACCOUNT (page 258).

From the Trading Account there can be ascertained not only the gross profit or loss but also the ratio of expenses and other items to sales. In this way variations as between one period and another become apparent and call for inquiry. The book-keeping

system should be so planned as to furnish these figures readily and should be on the same basis from year to year.

THE BALANCE SHEET

A Balance Sheet may be described as a summarized statement of the debit and credit balances in the Ledgers at a given date after a Profit and Loss Account has been raised and the profit or loss ascertained. Broadly speaking, it may be said to be a summarized statement of capital and liabilities on the one hand and assets on the other.

The capital, creditors, reserves, and so forth appear on the liabilities side of the Balance Sheet. The assets on the assets side of the Balance Sheet include real, personal, impersonal or nominal items. Section 124 of the Companies Act, 1929, provides *inter alia* that assets are to be distinguished in the Balance Sheet as fixed or floating assets. The manner in which the value of the fixed assets has been arrived at is to be stated. There must also be stated under separate headings, so far as not written off the preliminary expenses of the company, any expenses incurred in connexion with the issue of share capital or debentures and the amount of goodwill and of any patents and trade marks.

The value of the fixed assets for this purpose should consist of the original cost and subsequent additions, less what may have been written off as depreciation.

Fixed assets are in the main goodwill, freehold and leasehold land and buildings, plant and machinery, furniture, patents and copyrights, etc. If it were the business of a company to trade in any of the foregoing, such assets would become floating assets so far as they consisted of trading assets. The term "floating assets" in its general application relates to such items as cash, debtors, bills receivable, and stock-in-trade.

As regards the fixed assets it is not necessary to set out the cost, additions and depreciation separately. Where, for example, a factory has been written down to the nominal value of £1, the description "Cost plus additions less depreciation £1" would comply with the Act.

It is common practice to insert the heading "Liabilities" on the debit side of the Balance Sheet and "Assets" on the credit side, but this practice is not always followed on the grounds that undiscerning persons might not be aware of the qualifications as to assets referred to above and so be misled. As long as the facts are clear the question of heading is not a material point. In Scotland and on the Continent the headings are reversed; the liabilities appear on the credit side of the Balance Sheet and the assets on the debit side, as in fact they do in the Ledgers from which the Balance Sheet is compiled.

It cannot be said that there is any rule as to the order in which the liabilities and assets should be marshalled. In the case of companies it is usual to marshal the items in the following order—

On the Liabilities side share capital is the first item and is followed by debentures, loans and creditors. The balance of Profit and Loss Account is always the last item, whether it appears on one side or the other.

On the Assets side, goodwill, property and similar items come first, followed by the debtors, and balance at bank and cash in hand at the end. In the case of firms and sole traders, the order is often reversed.

The Companies Act, 1929, enacts as follows—

123. (2) The Directors shall cause to be made out in every calendar year, and to be laid before the company in general meeting, a Balance Sheet as at the date to which the Profit and Loss Account, or the Income and Expenditure Account, as the case may be, is made up, and there shall be attached to every such Balance Sheet a report by the Directors with respect to the state of the company's affairs, the amount, if any, which they recommend should be paid by way of dividend, and the amount, if any, which they propose to carry to the reserve fund, general reserve or reserve account shown specifically on the Balance Sheet, or to a reserve fund, general reserve or reserve account to be shown specifically on a subsequent Balance Sheet.

124. (1) Every Balance Sheet of a company shall contain a summary of of the authorized share capital and of the issued share capital of the company, its liabilities and its assets, together with such particulars as are necessary to disclose the general nature of the liabilities and the assets of the company and to distinguish between the amounts respectively of the fixed assets and of the floating assets, and shall state how the values of the fixed assets have been arrived at.

(2) There shall be stated under separate headings in the Balance Sheet, so far as they are not written off—

(*a*) the preliminary expenses of the company; and

(*b*) any expenses incurred in connexion with any issue of share capital or debentures; and

(*c*) if it is shown as a separate item in or is otherwise ascertainable from the books of the company, or from any contract for the sale or purchase of any property to be acquired by the company, or from any documents in the possession of the company relating to the stamp duty payable in respect of any such contract or the conveyance of any such property, the amount of the goodwill and of any patents and trade marks as so shown or ascertained.

(3) Where any liability of the company is secured otherwise than by operation of law on any assets of the company, the Balance Sheet shall include a statement that that liability is so secured, but it shall not be necessary to specify in the Balance Sheet the assets on which the liability is secured.

(4) The provisions of this Section are in addition to other provisions of this Act requiring other matters to be stated in Balance Sheets.

125. Where any of the assets of a company consist of shares in, or amounts owing (whether on account of a loan or otherwise) from a subsidiary company or subsidiary companies, the aggregate amount of those

assets, distinguishing shares and indebtedness, shall be set out in the Balance Sheet of the first-mentioned company separately from all its other assets, and where a company is indebted, whether on account of a loan or otherwise, to a subsidiary company or subsidiary companies, the aggregate amount of that indebtedness shall be set out in the Balance Sheet of that company separately from all its other liabilities.

126. (1) Where a company (in this Section referred to as "the holding company") holds shares either directly or through a nominee in a subsidiary company or in two or more subsidiary companies, there shall be annexed to the Balance Sheet of the holding company a statement, signed by the persons by whom in pursuance of Section one hundred and twenty-nine of this Act the Balance Sheet is signed, stating how the profits and losses of the subsidiary company, or, where there are two or more subsidiary companies, the aggregate profits and losses of those companies, have, so far as they concern the holding company, been dealt with in, or for the purposes of, the accounts of the holding company, and in particular how and to what extent—

(*a*) provision has been made for the losses of a subsidiary company either in the accounts of that company or of the holding company, or of both; and

(*b*) losses of a subsidiary company have been taken into account by the Directors of the holding company in arriving at the profits and losses of the holding company as disclosed in its accounts:

Provided that it shall not be necessary to specify in any such statement the actual amount of the profits or losses of any subsidiary company, or the actual amount of any part of any such profits or losses which has been dealt with in any particular manner.

(2) If in the case of a subsidiary company the Auditors' report on the Balance Sheet of the company does not state without qualification that the Auditors have obtained all the information and explanations they have required and that the Balance Sheet is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs according to the best of their information and the explanations given to them and as shown by the books of the company, the statement which is to be annexed as aforesaid to the Balance Sheet of the holding company shall contain particulars of the manner in which the report is qualified.

(3) For the purposes of this Section the profits or losses of a subsidiary company mean the profits or losses shown in any accounts of the subsidiary company made up to a date within the period to which the accounts of the holding company relate, or, if there are no such accounts of the subsidiary company available at the time when the accounts of the holding company are made up, the profits or losses shown in the last previous accounts of the subsidiary company which became available within that period.

(4) If for any reason the Directors of the holding company are unable to obtain such information as is necessary for the preparation of the statement aforesaid, the Directors who sign the Balance Sheet shall so report in writing and their report shall be annexed to the Balance Sheet in lieu of the statement.

128. (1) The accounts which in pursuance of this Act are to be laid before every company in general meeting shall, subject to the provisions of this Section, contain particulars showing—

(*a*) the amount of any loans which during the period to which the accounts relate have been made either by the company or by any other person under a guarantee from or on a security provided by the company

to any Director or officer of the company, including any such loans which were repaid during the said period; and

(*b*) the amount of any loans made in manner aforesaid to any Director or officer at any time before the period aforesaid and outstanding at the expiration thereof; and

(*c*) the total of the amount paid to the Directors as remuneration for their services, inclusive of all fees, percentages, or other emoluments, paid to or receivable by them by or from the company or by or from any subsidiary company.

(2) The provisions of subsection (1) of this Section with respect to loans shall not apply—

(*a*) in the case of a company the ordinary business of which includes the lending of money, to a loan made by the company in the ordinary course of its business; or

(*b*) to a loan made by the company to any employee of the company if the loan does not exceed two thousand pounds and is certified by the Directors of the company to have been made in accordance with any practice adopted or about to be adopted by the company with respect to loans to its employees.

(3) The provisions of subsection (1) of this Section with respect to the remuneration paid to Directors shall not apply in relation to a Managing Director of the company, and in the case of any other Director who holds any salaried employment or office in the company there shall not be required to be included in the said total amount of any sums paid to him except sums paid by way of Directors' fees.

(4) If in the case of any such accounts as aforesaid the requirements of this Section are not complied with, it shall be the duty of the Auditors of the company by whom the accounts are examined to include in their report on the Balance Sheet of the company, so far as they are reasonably able to do so, a statement giving the required particulars.

(5) In this Section the expression "emoluments" includes fees, percentages and other payments made or consideration given, directly or indirectly, to a Director as such, and the money value of any allowances or perquisites belonging to his office.

129. (1) Every Balance Sheet of a company shall be signed on behalf of the board by two of the Directors of the company, or, if there is only one Director, by that Director, and the Auditors' report shall be attached to the Balance Sheet, and the report shall be read before the company in general meeting, and shall be open to inspection by any member.

(2) In the case of a banking company registered after the fifteenth day of August, eighteen hundred and seventy-nine, the Balance Sheet must be signed by the secretary or manager, if any, and where there are more than three Directors of the company by at least three of those Directors, and where there are not more than three Directors by all the directors.

(3) If any copy of a Balance Sheet which has not been signed as required by this Section is issued, circulated, or published, or if any copy of a Balance Sheet is issued, circulated, or published without having a copy of the Auditors' report attached thereto, the company, and every Director, manager, secretary, or other officer of the company who is knowingly a party to the default, shall on conviction be liable to a fine not exceeding fifty pounds.

130. (1) In the case of a company not being a private company—

(*a*) a copy of every Balance Sheet, including every document required by law to be annexed thereto, which is to be laid before the company in general meeting, together with a copy of the Auditors' report, shall, not

less than seven days before the date of the meeting, be sent to all persons entitled to receive notices of general meetings of the company;

(*b*) any member of the company, whether he is or is not entitled to have sent to him copies of the company's Balance Sheets, and any holder of debentures of the company, shall be entitled to be furnished on demand without charge with a copy of the last Balance Sheet of the company, including every document required by law to be annexed thereto, together with a copy of the Auditors' report on the Balance Sheet.

If default is made in complying with paragraph (*a*) of this subsection, the company and every officer of the company who is in default shall be liable to a fine not exceeding twenty pounds, and if, where any person makes a demand for a document with which he is by virtue of paragraph (*b*) of this subsection entitled to be furnished, default is made in complying with the demand within seven days after the making thereof, the company and every Director, manager, secretary or other officer of the company who is knowingly a party to the default shall be liable to a fine not exceeding five pounds for every day during which the default continues, unless it is proved that that person has already made a demand for and been furnished with a copy of the document.

(2) In the case of a company being a private company,* any member shall be entitled to be furnished, within seven days after he has made a request in that behalf to the company, with a copy of the Balance Sheet and Auditors' report at a charge not exceeding sixpence for every hundred words.

If default is made in furnishing such a copy to any member who demands it and tenders to the company the amount of the proper charge therefor, the company and every officer of the company who is in default shall be liable to a default fine.

134. (1) The Auditors shall make a report to the members on the accounts examined by them, and on every Balance Sheet laid before the company in general meeting during their tenure of office, and the report shall state—

(*a*) whether or not they have obtained all the information and explanations they have required; and

(*b*) whether, in their opinion, the Balance Sheet referred to in the report is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs according to the best of their information and the explanations given to them, and as shown by the books of the company.

(2) Every Auditor of a company shall have a right of access at all times to the books and accounts and vouchers of the company, and shall be entitled to require from the Directors and officers of the company such information and explanation as may be necessary for the performance of the duties of the Auditors:

Provided that, in the case of a banking company which was registered after the fifteenth day of August, eighteen hundred and seventy-nine, and which has branch banks beyond the limits of Europe, it shall be sufficient if the Auditor is allowed access to such copies and extracts from such books and accounts of any such branch as have been transmitted to the head office of the company in Great Britain.

(3) The Auditors of a company shall be entitled to attend any general meeting of the company at which any accounts which have been examined or reported on by them are to be laid before the company and to make any statement or explanation they desire with respect to the accounts.

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* *For definition of a private company see Companies Act, 1929, Sect. 26.*

THE X.Y.Z. COMPANY LTD.

BALANCE SHEET, 31ST DECEMBER, 19....

Share Capital Authorized	Goodwill
........Ordinary Shares of £10 each	Freehold Premises as valued 31st December, 19....
........First Preference 5 per cent Shares of £10 each	Leasehold Premises at cost
........Redeemable Second Preference 7 per cent Shares of £10 each	Plant and Machinery at cost, less Depreciation at the rate of 10 per cent per annum
Share Capital Issued	Patents
........Ordinary Shares of £10 each fully paid	Trade Marks
........First Preference 5 per cent Shares of £10 each fully paid	Sundry Debtors (less reserve for doubtful debts)
........Second Preference 7 per cent Shares of £10 each redeemable on or before 31st December, 19....	Bills Receivable
Debentures (secured by floating charge on Assets other than Freehold Premises)	Stock in Trade
Mortgage (secured on Freehold Premises)	Work in Progress
Creditors on Open Account	Investments representing Reserve Fund at cost (Market Price £)
Bills Payable	Loans to Trustees in respect of shares held by Employees or by Employees for purchase of fully-paid shares
Reserve for Leases	Debentures in Subsidiary Companies (at cost)
Reserve Fund	Loans to Subsidiary Companies
General Reserve	Shares in Subsidiary Companies (at cost)
Reserve for Income Tax	Loans to Directors
Capital Redemption Reserve Fund	Loans made during year
Profit and Loss Account	*Less* amount paid off
Balance brought forward	Expenses of issue of Debentures—Balance not written off
Add Balance from Profit and Loss Account	Expenses of issue of Shares—Balance not written off
Less Preference Dividends paid	Preliminary Expenses—Balance not written off
	Discount on issue of shares—Balance not written off
	Advertising—Balance carried forward
	Balance at Bankers
	Cash in Hand

(Here follows Report of the Auditors)

E.F. & Co. (*Auditors*)

The Profits of the Subsidiary Companies have been included in the Profit and Loss Account to the extent of the Dividends paid by those Companies.

A.B.
C.D. } *Directors*

Note. The above is not a form of Balance Sheet; it is intended to indicate the more usual classifications of Liabilities and Assets.

In principle the Balance Sheet should be settled by the Directors and then submitted to the Auditors who will examine the Balance Sheet and make their report pursuant to Section 134 of the Companies Act, 1929. In practice the Directors and Auditors frequently meet and go into the accounts together, after which the Auditor settles his report, drawing attention, if necessary, to any points on which he is not satisfied, or which he considers should be brought to the notice of the shareholders. Not infrequently the Auditors themselves prepare the accounts.

In addition to making a report, the Auditor has a legal right under Section 134 to attend any general meeting at which the accounts which he has examined, and on which he has reported, are laid before the company, and to make any verbal statement or explanation he desires with respect to the accounts.

APPROPRIATION ACCOUNT

The balance of profits may be carried to an Appropriation Account or the appropriation may be set out in a summarized form in the Balance Sheet (see *pro forma* account on page 115).

The Appropriation Account or the summary in the Balance Sheet should open with the balance at the end of the previous financial period, set out how that balance was appropriated with the approval of the company in general meeting, and shew the resulting balance. To this balance is added the profit for the current period. Any income tax borne by the company, transfers to reserve, provision for redemption of debentures and items of that character, should be deducted. Any interim dividend paid to the shareholders since the last accounts were made up should also be deducted. The balance of the account shows the amount available for further appropriation. The recommendation of the Directors as to the appropriation of these profits is set out in the Directors' Report which should state the amount, if any, which they recommend be paid by way of dividend, and the amount, if any, which they propose to carry to reserve shown on the Balance Sheet or shown specifically on a subsequent Balance Sheet (Companies Act, 1929, Section 123 (2)). Any such recommendation approved by the shareholders at the annual general meeting will duly appear in the next Appropriation Account.

Debenture interest is a charge which has to be met whether there are profits or not, and it should not be treated as an appropriation of profits. If the interest exceeded the profits there would clearly be nothing to appropriate.

Properly drawn up the Appropriation Account or Summary enables the shareholders to follow the Accounts from year to year without difficulty.

The Auditor should see that the appropriations are in accordance

with the minutes of the directors' and shareholders' meetings, and have been duly given effect to in the books, for it occasionally happens that resolutions to carry sums to reserve or write down leases are overlooked by the company's officers.

APPROPRIATION ACCOUNT	Year Ended 31st December, 193.
Balance 1st January, 193.	
Deduct Transferred to General Reserve Dividend per cent less tax Staff Fund	
Add Net profit for year	
Deduct Transferred to Reserve for Income Tax Preference Dividend for half year to Expenses of Issue of Preference Shares	
Balance, carried to Balance Sheet	
Note. Instead of being shown as a separate account, the appropriation account may be shown on the Balance Sheet itself.	

Section 110 (3) of the Companies Act, 1929, provides as follows with regard to the contents of the annual return which must be filed with the Registrar of Companies—

(3) Except where the company is a private company, or is an assurance company which has complied with the provisions of subsection (4) of section Seven of the Assurance Companies Act, 1909, the annual return shall include a written copy, certified by a Director or the manager or secretary of the company to be a true copy, of the last Balance Sheet which has been audited by the company's Auditors, including every document required by law to be annexed thereto, together with a copy of the report of the Auditors thereon certified as aforesaid, and, if any such Balance Sheet is in a foreign language, there shall also be annexed to it a translation thereof in English, certified in the prescribed manner to be a correct translation.

Provided that, if the said last Balance Sheet did not comply with the requirements of the law as in force at the date of the audit with respect to the form of Balance Sheet there shall be made such additions to and corrections in the said copy as would have been required to be made in the said Balance Sheet in order to make it comply with the said requirements, and the fact that the said copy has been so amended shall be stated thereon.

A company forwarded to the Registrar a Balance Sheet purporting to be in compliance with Section 26 of the Companies (Consolidation) Act, 1908, which, in the statement of assets, set out the following particulars: "Goodwill, trade marks, machinery, furniture, and fixtures, £100,000. Goodwill and trade marks

at the sum at which they were taken over by the company. Machinery, furniture, and fixtures at cost, less depreciation."

Held, that this Balance Sheet did not comply with the requirements of Section 26, Subsection 4; by Lord Alverstone, C.J., because it stated that different parts of the fixed assets had been valued in different ways and did not state the separate values of those parts; by Pickford, J., because it ought to state the separate values of the tangible and intangible fixed assets.—*Galloway* v. *Schill, Seebohm & Co., Ltd.*, [1912] 2 K.B. 354.

In the present day such an amalgamation of assets would not satisfy the provisions of Section 124 of the Companies Act, 1929, which provides for the segregation of such items.

The Articles of a company contained the restrictions, limitations, and prohibitions mentioned in clauses (*a*), (*b*), and (*c*) respectively of Section 121, Subsection 1, of the 1908 Act (see Companies Act, 1929, Sections 26 and 27), but in each of two years the number of its members (exclusive of persons in the employment of the company) in fact exceeded fifty. Informations laid against the company for having in each of the two years respectively made default in forwarding to the Registrar of Companies a statement in the form of an audited Balance Sheet as required by Section 26, were dismissed by a magistrate upon the ground that the company was still a private company within the meaning of Section 121 and was therefore not bound to forward the statement—

Held, that the decision of the magistrate was right, inasmuch as a company whose Articles contained the restrictions, limitations, and prohibitions mentioned in clauses (*a*), (*b*), and (*c*) of Subsection 1 of Section 121 remains a "private company" within the meaning of the definition contained in the Section, even though those restrictions, limitations, and prohibitions are not in fact complied with by the company.—*Park* v. *Royalties Syndicate, Ltd.*, [1912] 1 K.B. 330.

Every calendar year means a year from 1st January to 31st December.—*Gibson* v. *Barton* (1875), L.R. 10 Q.B. 329; *Edmonds* v. *Foster* (1876), 33 L.T. 690.

A Director is not necessarily personally responsible for Balance Sheets and reports stated to be issued "by order of the Directors."—*Re Denham & Co.* (1884), 25 Ch.D. 752.

PROFIT AND LOSS ACCOUNT

This account should set out on the credit side the gross profit as shown by the Trading Account and any other credit items such as income from investments, transfer fees or exceptional profits of a non-recurring nature, for example, profit on sales of investments of any kind if under the Articles of Association it be

permissible to treat these profits as divisible, and on the debit side the various expenses not chargeable in the Manufacturing or Trading Account. Any exceptional losses such as loss on the realization of investments written off out of profits should be shown separately.

PROFIT AND LOSS ACCOUNT for the Year Ended 31st December, 1934

Dr.	*Cr.*
To Salaries	By Gross Profit
,, Travelling Expenses	,, Rents
,, Printing and Stationery	,, Transfer Fees
,, Postages and Telegrams	,, Interest
,, Insurance	,, Exchange
,, Advertising	,, Balance, being Net Loss for the Year
,, Sundry Expenses	
,, Commission	
,, Pensions	
,, Discount	
,, Maintenance of Buildings	
,, Foreign Agencies—Expenses	
,, Depreciation—Fixtures and Fittings	
,, Trade Mark Renewals	
,, Interest and Bank Charges	
,, Secretarial	
,, Directors' Fees	
,, Professional Charges	
,, Written off Finished Stock	
,, Bad Debts	
,, Commissions to Managers	
,, Staff Bonus	
,, Balance, being Net Profit for the year	

It is an ancient truism that if the Balance Sheet be sound, the Profit and Loss Account must also be sound, for the Profit and Loss Account is but an amplification of the balance of Profit and Loss Account appearing in the Balance Sheet. The audit of a Balance Sheet necessarily involves the verification of the balance of the Profit and Loss Account which it includes. This verification naturally follows from the audit of the books, which contain the accounts carried to the Profit and Loss Account.

Section 123 of the Companies Act, 1929, is as follows—

123. (1) The Directors of every company shall at some date not later than eighteen months after the incorporation of the company and subsequently once at least in every calendar year lay before the company in general meeting a profit and loss account or, in the case of a company not trading for profit, an income and expenditure account for the period, in the case of the first account, since the incorporation of the company, and, in any other case, since the preceding account, made up to a date not earlier than the date of the meeting by more than nine months, or, in the case of a company carrying on business or having interests abroad, by more than twelve months:

Provided that the Board of Trade, if for any special reason they think fit so to do, may, in the case of any company, extend the period of eighteen

months aforesaid, and in the case of any company and with respect to any year extend the periods of nine and twelve months aforesaid.

123. (2) The Directors shall cause to be made out in every calendar year and to be laid before the company in general meeting, a Balance Sheet as at the date to which the Profit and Loss Account, or the income and expenditure account, as the case may be, is made up, and there shall be attached to every such Balance Sheet a report by the Directors with respect to the state of the company's affairs, the amount, if any, which they recommend should be paid by way of dividend, and the amount, if any, which they propose to carry to the reserve fund, general reserve or reserve account shown specifically on the Balance Sheet, or to a reserve fund, general reserve or reserve account to be shown specifically on a subsequent Balance Sheet.

(3) If any person being a director of a company fails to take all reasonable steps to comply with the provisions of this section, he shall, in respect of each offence, be liable on summary conviction to imprisonment for a term not exceeding six months or to a fine not exceeding two hundred pounds.

Under this Section it appears that the Profit and Loss Account need only be laid before the company in general meeting, but it is provided that the Balance Sheet is to be made up as at the date to which the Profit and Loss Account is made up. Actually the usual practice is to issue a copy of the Profit and Loss Account with the annual Balance Sheet, and if it is so laid down in the Articles of Association the Directors must do so. The Auditor does not sign a report on the Profit and Loss Account, which, as mentioned before, is only an explanatory account of a Balance Sheet item, but there is no doubt that shareholders would lose confidence in an Auditor who did not draw attention to anything of a misleading nature in the Profit and Loss Account published in conjunction with the Balance Sheet, even if he could be said to have fulfilled his statutory obligations. If the Profit and Loss Account is simply laid before a general meeting the Auditor would apparently be under no responsibility, if the balance carried to the Balance Sheet were correct and properly described This, however, is a narrow interpretation of the Auditor's duties, and he would do well to take a more liberal view of his obligations to the shareholders.

ACCOUNT OF RECEIPTS AND PAYMENTS (CASH ACCOUNT)

Those who understand accounts will appreciate the fact that it would be obviously absurd for the Directors of a company to prepare a Cash Account and place it before its shareholders as a document on which they would determine whether or not a dividend might be declared, based on the balance in hand at the end of the period. This, however, has actually happened. In a case in which the Directors of a company which had been in existence only eight months declared a bonus, James, L.J., said: "A bonus, which of course could only be lawfully made out of

moneys which had been earned, or believed to have been earned, in the way of profit. . . . How was this done? Was there any attempt to make a Balance Sheet or Profit and Loss Account in such a way as any mercantile body, and certainly any Insurance Company, ought to have done? . . . The Directors simply had before them the cash balance of the receipts and payments, and, without making the slightest provision on that account for anything whatever, they proceed out of the balance to declare this bonus. I quite agree that it would have been different if there had been, as there ought to have been, in the ordinary course of business, a Balance Sheet *bona fide* made out with proper assistance, so as to ascertain the true state of the Company."—*Rance's Case, Re County Marine Insurance Co.* (1870), 6 Ch. App. 104.

This account differs from an Income and Expenditure Account in that it only records actual cash transactions and ignores what is outstanding, whether receivable or payable, relating to the period for which the account is drawn up; it therefore does not show the surplus income, but only the balance of cash on hand.

Building societies are compelled by law to submit a Cash Account (see page 226), but otherwise this form of account is mainly used in Government accounting and in some classes of legal procedure.

The Auditor's certificate to an account of this nature must of necessity depend on the evidence as to the receipts and payments produced to him.

CHAPTER X

PROFITS AVAILABLE FOR DISTRIBUTION

THE question of the determination and ascertainment of profits is one of special importance. The principles involved are considered elsewhere in this book, and the computation in some respects follows a definite procedure. In other respects, however, points may arise as to the inclusion or exclusion of certain items, where the issue is a matter of opinion. For example, prudence may suggest reserves and special provisions for depreciation, contingencies and similar matters, although it might be impossible to state that the accounts without such provisions are incorrect. Nor can a decision be arrived at without taking into account the various interests concerned—creditors, debenture holders, shareholders and others. The improper payment of a dividend which may result from an excessive statement of profits will possibly affect the position of debenture holders and creditors by depleting the assets to which they look to meet their claims. The understatement of profits, on the other hand, may have the effect of depriving present shareholders of dividends to which they are entitled, or depressing the market value of their shares, though this latter aspect is not one which should necessarily weigh with the directors in determining their policy.

It is not surprising, therefore, that the question of ascertainment of profits and the propriety of the payment of dividends should have been the subject of many cases in the Courts, and it is appropriate here to cite a number of these cases and the decisions given, so that the principles involved may be understood.

Ammonia Soda Co. Ltd. v. *Chamberlain*, [1918] 1 Ch. 266

In this case it was decided that a company may write up the assets as the result of a *bona fide* revaluation and may divide current profits without making good previous losses.

The company had written up the value of certain lands and used the increase in value to write off a balance at the debit of Profit and Loss Account, goodwill and a cash bonus paid.

Peterson, J., in the course of a long judgment, said—

The Directors, no doubt, would have been better advised if they had obtained a revaluation from some expert valuer, although, if one may judge by the evidence on the subject which I have heard, the margin of difference between the views of values on the subject is very great. But there is no rule of law which requires Directors to obtain outside assistance in such matters or prevents them from valuing the property themselves, provided, of course, that they act honestly in doing so.

There is not any ground for suggesting that any facts were concealed from the shareholders by the Directors. In these circumstances it is not, in my opinion, open to the company to attack the Directors for an honest, though it may be erroneous, estimate which has been expressly adopted by the company in general meeting after the attention of its shareholders had been pointedly called to the resolution by the Auditors' certificate which was attached to the Balance Sheet.

I am satisfied that the Directors acted honestly. What they proposed to do was clearly shown in the Balance Sheet and the Auditors' report, which were submitted to the general meeting of the company in October, 1911. Most, if not all, of the shareholders who attended that meeting were commercial men, and they unanimously approved of the proposal. The Auditors, while they properly called attention to the revaluation by the Directors and to the way in which it was proposed to apply the increase in the value of the land, do not appear to have advised the Directors or the shareholders that there was any impropriety in dealing with the increase in this way; and the same firm of Auditors and an additional firm of Auditors, both of whom were admittedly experienced Chartered Accountants, certified the Balance Sheet at 31st January, 1912, without suggesting any doubts as to the correctness of the course which had been pursued.

Note. The essence of this case is that the fact that there is a debit balance to Profit and Loss Account arising out of previous losses does not make it illegal to pay dividends out of subsequent profits without first of all providing for the previous losses.

From a financial point of view this does not appear to be a sound policy and is open to abuse.

By the special Act of a Gas Company it was provided that the profits to be divided among the shareholders in any year should not exceed a given rate. It was held that in arriving at the rate of dividend the profits ought to be calculated as inclusive and not exclusive of the amount payable for the year in respect of income tax.—*Ashton Gas Co.* v. *Attorney-General*, [1906] A.C. 10.

Boaler v. *Watch Makers' Alliance* (1903), *Accountant Law Reports* 23

The liability of the Directors in respect of dividends improperly paid out of capital ceases when the amount so paid is covered by subsequent profits. This principle would presumably also apply to Auditors.

Bolton v. *Natal Land & Colonization Co., Ltd.*, [1892] 2 Ch. 124

In this case it was held that a company may declare a dividend out of current profits although there has been a loss of part of the capital assets.

In one year the company wrote off a bad debt of £70,000, but on the other hand credited to Profit and Loss Account a sum of £70,000, being an increase in value attributed to certain lands as compared with the amount standing in the books. A few years

later the company, having earned a profit, paid a dividend out of these profits. The plaintiff commenced an action to restrain the payment of the dividend on the grounds that the land should be written down to its true value. The judgment was as follows—

Held that, assuming that a part of the capital had in fact been lost, and not subsequently made good, no sufficient ground was thereby afforded for restraining the payment of the dividend; that the fact of the company having written up the value of their land in 1882, and credited the increase to the profit of that year in the manner prescribed, did not place them under any obligation to bring into account in every subsequent year the increase or decrease in the value of their lands; and that, having regard to the case of *Lee* v. *Neuchatel Asphalte Co.* (1889), 41 Ch.D. 1, it was not correct, in estimating the profits of a year, to take into account the increase or decrease in the value of the capital assets of the company.

This procedure has been followed by other companies. It is, however, bad finance to bring in unrealized values as a profit. A dividend paid in cash out of unrealized profits of this character would seem to be inadvisable even though not illegal.

Articles of Association of the usual type would not permit of dividends being paid out of unrealized increases in value, even if the object of the company were to trade in land.

Bond v. *Barrow Haematite Steel Company*, [1902] 1 Ch. 353

This case decided that preference shareholders cannot claim to receive dividends out of current profits as a matter of right and regardless of such provisions for reserves as the Directors may think fit.

The substance of the decision is as follows—

The case of *Lee* v. *Neuchatel Asphalte Co.* (1889), 41 Ch. D.1, in which the doctrine was laid down that there is nothing in the Companies Act, 1862, and subsequent Acts, to prohibit a company formed to work a wasting property, as e.g. a mine or patent, from distributing, as dividends, the excess of the proceeds of working above the expenses of working, nor to impose on the company any obligation to set apart a Sinking Fund to meet the depreciation in the value of the wasting property, has been misunderstood. The Court decided nothing more than the particular proposition that some companies with wasting assets need have no depreciation fund.

The question whether a company has profits available for distribution must be answered according to the circumstances of each particular case, the nature of the company, and the evidence of competent witnesses.

Bosanquet v. *St. John d'El Rey Mining Co., Ltd.* (1911), 103 L.T. 316

A company formed in 1830 for the purpose of working gold mines in Brazil, made large profits from its principal mine, and paid good dividends from 1835 to 1886, when the top of the mine fell in and blocked it up, making further work impossible without an expenditure of large sums of money for labour and machinery in reopening it. To obtain the necessary funds for this purpose the company was twice reconstructed, and its capital increased by the issue of shares and of debentures bearing interest at £10 per cent per annum; and in November, 1894, the mine was re-opened and supplied with new machinery and plant. From the date of the issue of the debentures up to the date of reopening, the company made no profits, and the Directors paid the interest on the debentures, which amounted to a large sum, out of capital, but after November, 1894, the debenture interest and all outgoings were paid out of income. The Directors decided to form a Sinking Fund out of profits for the purpose of recouping the amount paid out of capital, and from the profits of the year 1897 proposed to pay a small dividend and to carry over the remainder to the credit of the Sinking Fund. Upon motion in an action by a debenture-holder and shareholder, on behalf of himself and all other debenture-holders and shareholders of the company, for an injunction restraining the Directors from applying any part of the profits in payment of a dividend until the amount paid out of capital for debenture interest had been replaced, it was held that the company were not bound to apply the profits in replacing debenture interest paid out of capital in previous years before declaring a dividend, and the action was dismissed.

Re Crighton's Oil Company, [1901] 2 Ch. 197

In this case Wrightly, J., said—

I do not think that there is any rule of law that profit on one year's trading account cannot be divided merely because on the Profit and Loss Account there is a deficit over the balance of former years; but it does not follow from that that the amount of the profit of one year is necessarily to be treated as available for dividends. . . . Profit is not an automatic thing, nor is a divisible profit an automatic thing.

Burnes v. *Pennell* (1849), 2 H.L.C. 535

As long ago as 1849, Campbell, L.C., intimated that dividends are supposed to be paid out of profits only, and where Directors order a dividend to any given account, without expressly saying so, that implicitly declares to the world that the company has made profits which justify such a dividend. He added that if no such profits had been made, and the dividend had to be paid out of the capital of the concern, a gross fraud was practised, and in

his opinion Directors were not only civilly liable to those whom they had deceived and injured, but were guilty of a conspiracy, for which they were liable to be prosecuted and punished.

Cox v. *Edinburgh & District Tramways Company* (1898), 6 S.L.T. 63

The company had altered its system from horse traction to cable traction. It was held that nothing need be written off capital account before paying dividends out of current profits.

In the course of the judgment Lord Kyllachy said—

I proceed on a principle as old as the beginning of company law—the principle, namely, that in matters of the kind here in question—matters necessarily of estimate and opinion—a company is presumably the best judge of its own affairs. In such matters the Court will not readily interfere with the company's action, and it will not do so at all except on averments which involve practically a case of fraud or dishonesty. But, apart from extreme cases, few things are, I should think, more common in ordinary business than operations of the kind with which we are concerned. A merchant or manufacturer desires to enlarge his premises, satisfied that it will pay him to do so. He accordingly pulls down old buildings which have a certain value and he replaces them by others at perhaps great cost. There is thus, of course, in a sense, the sacrifice of a permanent asset, and it may quite well happen that the new buildings if put into the market would not fetch a sum equal to the value of the old building plus the cost of the new. But for the purposes of the trader's business the result may be entirely the other way, and the presumption is that the trader is satisfied that it is so. If he is so satisfied he will certainly not consider that he has sustained a loss of capital, or feel bound to carry the cost of the old building to the debit of his Profit and Loss Account for the year. Similarly, a manufacturer requires or resolves to discard certain machinery and to replace it with other machinery more effective or more economical. Here, again, the sacrifice in the case of the old machinery is simply an item in the cost of the change. So also, when a railway company, as sometimes happens, alters its gauge, or substitutes, say, steel for iron rails. The operation necessarily involves a sacrifice of old material. But the assumption always is that the operation as a whole enhances the value of the concern or undertaking. And although it may be a prudent and proper thing to provide for the recurrence of such expenditure, and to set up a renewal fund, that is a question which the trader considers for himself, and one as to which, even in the case of limited companies, courts of law are not accustomed to interfere. On the whole matter I am of opinion that the complainer has stated no relevant case for interfering with the proposed dividend, or for granting him interdict in terms of any part of his prayer.

Foster v. *New Trinidad Lake Asphalte Co., Ltd.*, [1901] 1 Ch. 208

It was held in this case that a realized addition to the estimated value of one item of the capital assets taken over by a company at its formation cannot be deemed to be profit available for dividends without reference to the result of the whole accounts, fairly taken.

Byrne, J., said—

It appears to me that the amount in question is *prima facie* capital, and that I have no evidence which would justify me in saying that it has changed its character because it has turned out to be of greater value than had been expected. If I rightly appreciate the true effect of the decisions the question of what is profit available for dividend depends upon the result of the whole accounts fairly taken for the year, capital, as well as profit and loss, and although dividends may be paid out of earned profits in proper cases, although there has been a depreciation of capital, I do not think that a realized accretion to the estimated value of one item of the capital assets can be deemed to be profit divisible amongst the shareholders without reference to the result of the whole accounts fairly taken.

Note. The contents of the Memorandum and Articles of Association must be studied in considering a case of this character.

Helby's Case, re Portsmouth Banking Co. (1866), L.R. 2 Eq. 167

Kindersley, V.C., said—

The Balance Sheet or summary of account would show, on the one hand, all the assets, and, on the other hand, all the liabilities of the company, and it was only on this sort of statement that any safe conclusion could be drawn as to the question whether there had been any profit for the half-year or not, and whether any and what dividend should be declared.

Note. This bears out the principle that if the Balance Sheet is sound the Profit and Loss Account must also be sound.

Lubbock v. *British Bank of South America Ltd.*, [1892] 2 Ch. 198

Where a Banking Company with a paid-up capital of £500,000 sold part of its undertaking for £875,000, and after deducting the paid-up capital and other incidental expenses there remained a net balance of £205,000, and the Directors proposed to treat this balance as profit, it was held by Chitty, J., that the £205,000 was profit on capital, and not part of the capital itself, that the Directors were justified in carrying this sum to the Profit and Loss Account, and, after appropriating to the Reserve Fund so much as they thought proper, might distribute the remainder as dividends.

There was nothing in the Articles of Association preventing the company from dividing profits of a capital nature.

Re The Midland Land and Investment Corporation (1886), Unreported

In this case, which was not reported, Chitty, J., said—

In declaring a dividend, in my opinion, in trading concerns, the Directors are entitled to put an estimate on the value of their assets from time to time, in order to ascertain whether there is or is not a surplus remaining after providing for liabilities (including, of course, paid-up capital), and where they make those valuations from time to time on a just and fair

basis, and take all the precautions which ordinary prudent men of business engaged in a similar business would do, they are entitled to treat the surplus thus ascertained as profit.

Note. This decision may not always be in accordance with the principles of sound finance since dividends have to be paid in cash, which is not provided by re-valuations.

Moxham v. *Grant*, [1900] 1 Q.B. 88

Where dividends are received by shareholders who know that they have been paid out of capital, the Directors have a right to be indemnified by the shareholders, but not if they have represented that the dividends were paid out of profits.

Stapley v. *Read Bros. Ltd.* (1924), 40 T.L.R. 442

A company which has written down its assets excessively out of profits may write up the assets again by the amount of the excess and apply the amount in payment of dividends.

The plaintiff sought an injunction to restrain the defendant company (1) from distributing in dividend the credit balance of the Profit and Loss Account at 31st December, 1923, or any part thereof, until the debit balance on the Profit and Loss Account at 31st December, 1922, had been discharged, and (2) from treating as profits available for dividend (*a*) any profits originally applied in writing off or down the book value of any of the assets, and subsequently written back on the ground that such assets stood in the company's books at less than their true value; (*b*) any unrealized profit arising from an estimated increase in the value of any capital asset.

Russell, J., refused to grant the injunction. He said—

The sole question was whether profit and loss was to be treated as a continuous account, so that no dividend could be declared out of one year's profits until any debit to profit and loss in respect of prior years had been made good.

His Lordship said that this point was covered by the decision in *Ammonia Soda Co., Ltd.* v. *Chamberlain*, [1918] 1 Ch. 266, and he therefore refused to grant the injunction.

In dealing with the second part of the motion his Lordship said that the point was not covered by direct authority. Had the company retained the goodwill as an asset in the Balance Sheet, and, instead of writing off its value out of profits, had carried those profits to a goodwill depreciation reserve fund, it could have distributed those profits at any time to the extent by which the amount of the reserve fund exceeded the amount of actual depreciation. It was admitted that the value of the goodwill was at least £40,000, and if therefore there had been £40,000 to the credit of that reserve fund, the company could have distributed

without first making good the capital which has been lost. I have no doubt it can—that is to say, there is no law which prevents it in all cases and under all circumstances. Such a proceeding may sometimes be very imprudent, but a proceeding may be perfectly legal and may yet be opposed to sound commercial principles. We, however, have only to consider the legality or illegality of what is complained of. The main fact is that the main condition of limited liability is that the capital of a limited company shall be applied for the purposes for which the company is formed, and that to return the capital to the shareholders either in the shape of dividend or otherwise is not such a purpose as the Legislature contemplated. But there is a vast difference between paying dividends out of capital and paying dividends out of other money belonging to the company, and which is not part of the capital mentioned in the company's memorandum of association. The capital even of a limited company is not a debt owing by it to its shareholders, and if the capital is lost the company is under no legal obligation either to make it good or, on that ground only, to wind up its affairs. If, therefore, the company has any assets which are not its capital within the meaning of the Companies Acts, there is no law which prohibits the division of such assets amongst the shareholders. There is no law which prevents a company from sinking its capital in the purchase or production of a money-making property or undertaking, and in dividing the money annually yielded by it without preserving the capital sunk so as to be able to reproduce it intact either before or after the winding up of the company. A company may be formed upon the principle that no dividends shall be declared unless the capital is kept undiminished, or a company may contract with its creditors to keep its capital or assets up to a given value. But in the absence of some special Article or contract there is no law to this effect, and, in my opinion, for very good reasons. It would, in my judgment, be most inexpedient to lay down a hard and fast rule which would prevent a flourishing company either not in debt or well able to pay its debts from paying dividends so long as its capital sunk in creating the business was not represented by assets which would, if sold, reproduce in money the capital sunk. Even a sinking fund to replace lost capital by degrees is not required by law. But, although there is nothing in the statutes requiring even a limited company to keep up its capital, and there is no prohibition against payment of dividends out of any other of the company's assets, it does not follow that dividends may be lawfully paid out of other assets regardless of the debts and liabilities of the company. A dividend presupposes a profit in some shape, and to divide as a dividend the receipts, say, for a year, without deducting the expenses incurred in that year in producing the receipts, would be as unjustifiable in point of law as it would be reckless and blameworthy in the eyes of business men. The same observation applies to payment of dividends out of borrowed money. Further, if the income of any year arises from a consumption in that year of what may be called circulating capital, the division of such income as dividend without replacing the capital consumed in producing it will be a payment of a dividend out of capital within the meaning of the prohibition which I have endeavoured to explain. It has been already said that dividends presuppose profits of some sort, and this is unquestionably true. But the word "profits" is by no means free from ambiguity. The law is much more accurately expressed by saying that dividends cannot be paid out of capital than by saying that they can only be paid out of profits. The last expression leads to the inference that the capital must always be kept up and be represented by assets which, if sold, would produce it; and this is more than is required by law. Perhaps the shortest way of expressing the distinction which I am endeavouring to explain is to

say that fixed capital may be sunk and lost, and yet that the excess of current receipts over current payments may be divided, but that floating or circulating capital must be kept up, as otherwise it will enter into and form part of such excess, in which case to divide such excess without deducting the capital which forms part of it will be contrary to law. But there is no law which compels limited companies in all cases to recoup losses shown by the Capital Account out of the receipts shown in the Profit and Loss Account, although care must be taken not to treat capital as if it were profit. Further, it is obvious that capital lost must not appear in the accounts as still existing intact; the accounts must show the truth and not be misleading or fraudulent.

Wall v. *London & Provincial Trust, Ltd.*, [1920] 1 Ch. 45

In this exceptional case it was held that a company which by its Articles of Association adopts the double account system cannot in law treat profits made on the redemption of its debentures as being available for dividend.

The action was brought against the Trust Investment Company to prevent distribution by way of dividend of profits made by redemption of Debentures at a discount.

Younger, J., said—

Where the double account system exists, no transfer can be made from one account to another. An appreciation of capital can never increase the income balance. To do this the single account system must be adopted, which is not in accordance with the constitution of this company. This discount is not either net profit of the company or net profit arising from its business and the directors are not entitled to distribute it as dividend.

Note. In subsequent proceedings reported in [1920] 2 Ch. 582, the decision of Younger, J., was approved and followed.

Wilmer v. *McNamara & Co., Ltd.*, [1895] 2 Ch. 245

In this case it was held that a company cannot be restrained from declaring a dividend out of current profits because no provision has been made for depreciation of fixed assets. The ordinary shareholders in the company sought to restrain the Directors from paying a dividend to the preference shareholders. The object of the action was to ascertain whether the dividend could be lawfully paid, in view of the fact that there had been a loss of capital which it was contended should be made good before any dividends were paid. Stirling, J., in refusing to make an injunction against the Directors, said—

Article 117 provides that "no dividend shall be payable except out of the profits arising out of the business of the company." What are these profits? Apart from the use of the word "profits" in Article 117, there is nothing in the Articles to show that the capital of the company (or, rather, assets of the value of those acquired by the company at its formation) must be kept up. Further, the Articles appear to contemplate "profits"

as the excess of receipts over all expenditure properly attributable to the year. It is necessary, however, to consider whether the depreciation in goodwill and leaseholds is to be treated as loss of "fixed" capital or of "floating" or "circulating" capital, and on this point I am of opinion that it is to be treated as loss of "fixed" capital. It very closely resembles the loss which a railway company may be said to suffer if it be found that their line, which was made, say, ten years ago, at a certain cost, could now be made at a much smaller cost. Having regard to the remarks of Lindley, L.J., in *Lee* v. *Neuchatel Asphalte Co.* (see page 136), I think that the Balance Sheet cannot be impeached simply because it does not charge anything against revenue in respect of goodwill. I feel much more doubt whether £200 is a sufficient sum to allow in respect of depreciation of leaseholds, but I do not think under the circumstances that a case has been made out for an injunction, and the motion must be refused.

The Balance Sheet of a company engaged in a hazardous trade will not be considered delusive and fraudulent merely because an estimated value was put upon assets of the company which were then in jeopardy, and were subsequently lost, or because the company was obliged to borrow money to pay the dividend, provided the facts fairly appeared in the Balance Sheet, and the balance fairly represented profits.—*Re Mercantile Trading Co., Stringer's Case* (1869), 4 Ch. App. 475.

Where the Articles of Association of a limited company provided that no dividends should be payable except out of "realized profits," it was held that "realized profits" must be taken in its ordinary commercial sense, as meaning at least the profits tangible for the purpose of division, and that the Directors, having treated estimated profits as realized profits, and having in fact paid dividends out of capital, on the chance that sufficient profits might be made, were held generally and severally liable.—*Re Oxford Benefit Building and Investment Society* (1887), 35 Ch.D. 502.

The Memorandum of Association of a company contained this clause: "The capital of the company is £150,000, divided into 10,000 ordinary shares of £10 each, and 5000 preference shares of £10 each. The holders of preference shares shall be entitled out of the net profits of each year to a preference dividend at the rate of £10 per cent per annum on the amount for the time being paid or deemed to be paid up thereon. After payment of such preferential dividend, the holders of ordinary shares shall be entitled to a like dividend at the rate of £10 per cent per annum on the amount paid on such ordinary shares. Subject as aforesaid, the preference and ordinary shares shall rank equally for dividend." It was held that the preference shareholders were not entitled to a cumulative dividend of £10 per cent so as to have the deficiency in one year paid out of the profits of a subsequent year before paying anything to the ordinary shareholders.—*Staples* v. *Eastman Photographic Materials Co., Ltd.*, [1896] 2 Ch. 303.

Where the Articles of Association provided that the Directors may "declare a dividend to be paid to the members in proportion to their shares," and by the definition clauses the word "capital" was declared to mean the capital for the time being of the company, and the word "shares" the shares into which the capital is divided, it was held that all the shares were entitled to participate equally in dividend, without regard to the amount paid up upon each.—*Oakbank Oil Co.* v. *Crum* (1883), 8 App. Cas. 65.

The Articles of a company provided for the submission of accounts up to a date within three months and reports thereon, the sanction of a dividend, and the transaction of the ordinary business at the annual general meeting. It was held by North, J., that a final dividend could not be sanctioned except at an annual general meeting, at which accounts up to the prescribed date and reports thereon were submitted.—*Nicholson* v. *Rhodesia Trading Co., Ltd.*, [1897] 1 Ch. 434.

Where the Articles of Association of a company made no provision for the payment of dividends other than this: "The Directors may . . . declare and divide an interim dividend out of the profits . . . and pay the same to the members in proportion to the capital held by each," and when the Directors were further empowered to receive advances from any member of any sums due upon the shares held by him beyond what was actually called up, and to pay interest "in lieu of dividends" thereon, and "capital" was not defined in the Articles, it was held that the dividends fell to be apportioned according to the amount of the paid-up capital of each shareholder.—*Hoggan* v. *Tharsis Sulphur & Copper Co.* (1882), 9 R. (Ct. of Sess.) 1191 (Sc.).

Where a company issues preference shares carrying dividend at 10 per cent per annum, payable half-yearly, and with no words restricting the holders of such shares to the profits of the current year, the deficiency in the profits of any one year to pay the 10 per cent in full was, as between the preference and ordinary shareholder, to be made good out of subsequent profits.—*Foster* v. *Coles and M. B. Foster & Sons, Ltd.*, [1906] W.N. 107.

"Profits available for dividend" mean the net profits after making any deductions which Directors can properly make before declaring a dividend.—*Fisher* v. *Black and White Publishing Co., Ltd.*, [1901] 1 Ch. 174.

When a company declares a dividend on its shares, a debt immediately becomes payable to each shareholder in respect of his dividend, for which he can sue at law, and the Statute of Limitations immediately begins to run. The declaration does not make the company a trustee of the dividend for the shareholder, and an entry of the liability in the company's books—at any rate when no special part of its assets is set aside as representing the

dividend and no notice of the entry is given to the shareholders—does not take the case out of the statute. Being payments under the Articles of Association, dividends are specialty debts, and consequently the period of limitation is twenty years.—*Re Drogheda Steam Packet Company*, [1903] Ir. R. 512. The same principle was asserted *Re Artisans' Land and Mortgage Corporation*, [1904] 1 Ch. 796.

In a case where the Directors of a company which had been in existence only eight months declared a bonus, James, L.J., said—

> A bonus, which of course can only be lawfully made out of moneys which have been earned, or believed to have been earned, in the way of profit. . . . How was this done? Was there any attempt to make a Balance Sheet or Profit and Loss Account in such a way as any mercantile body, and certainly any Insurance Company, ought to have done? . . . The Directors simply had before them the cash balance of the receipts and payments, and, without making the slightest provision on that account for anything whatever, they proceed out of the balance to declare this bonus. I quite agree that it would have been different if there had been, as there ought to have been, in the ordinary course of business, a Balance Sheet *bona fide* made out with proper assistance, so as to ascertain the true state of the company.—*Rance's Case, Re County Marine Insurance Co.* (1870), 6 Ch. App. 104.

Outstanding interest should not be taken to credit of a Profit and Loss Account until the claim is statute-barred, and not even then unless the Directors have decided not to recognize the claim should it subsequently be made.

The same remark applies to interest unclaimed by debenture-holders, and in the case of a Railway Company incorporated by a special Act, authorizing it to issue debenture stock, bearing interest, subject to Part III (which includes Sections 22 and 27) of the Companies Clauses Act, 1863, which issued debenture stock, for which it gave certificates under its common seal, and also a warrant for interest under the signature of its Secretary, it was held that, the liability being statutory, the period of limitation was twenty years.—*Re Cornwall Minerals Railway Co.*, [1897] 2 Ch. 74

Dividends may not be paid out of borrowed capital, nor can interest on debentures be charged to Capital Account.—*Bloxam* v. *Metropolitan Railway Co.* (1868), 3 Ch. App. 337.

In the following case, reported in *The Times* of 30th July, 1936, the question for decision was "What were profits?" for the purposes of an agreement under which the plaintiff was entitled to £1000 "out of the first profits of the company and in priority to all dividends payable in respect of any shares in the capital of the company."

In 1930 the defendant company was formed for the manufacture

of a flash lamp used in photography, and in consideration of services rendered in the flotation the defendants by an agreement dated 20th December, 1930, agreed to pay to the plaintiff £1000 "out of the first profits of the company and in priority to all dividends payable in respect of any shares in the capital of the company." The company's Balance Sheet for the year ended 31st March, 1935, showed a balance of £698 11s. 10d. to the credit of the Profit and Loss Account, and the plaintiff claimed this sum on account of the £1000 due to him under the agreement. The directors of the company refused to pay the £698 11s. 10d. to the plaintiff and applied it as to £393 odd in writing off the company's preliminary expenses, and the remaining £304 odd they placed to the patents reserve account.

Mr. Justice Branson, in delivering judgment for the defendants, said that the plaintiff contended that the £698 11s. 10d. was the "first profits" earned by the company inasmuch as it appeared in the Profit and Loss Account. The defendants contended that on a true construction of the agreement the plaintiff was to be the first person to benefit out of profits which, if he had not been there, would have gone to the shareholders.

A number of cases had been cited, but it was difficult to get any help from them. It was contended that it was a reasonable and prudent course for the directors of the company to write off the preliminary expenses and put something to reserve. Patents were wasting assets, and directors ought to provide for the replacement of wasting capital. As the authorities were not helpful he was driven back on the construction of the words of the agreement. What were the profits of a company was a question to which different answers might be given (*Lee* v. *Neuchatel Asphalte Co.*, 41 Ch.D. 1). It was essential to look at the whole of the language used by the parties and read the whole together. He thought that the words here must be read "when the directors come to consider the payment of a dividend they must first pay the plaintiff his £1000 out of the money which would otherwise be available for dividend."

It was argued that on that construction the directors might postpone the payment of a dividend and so keep the plaintiff out of his money indefinitely; but the company was floated with the intention of paying dividends to its shareholders and such postponement was unlikely. The plaintiff was safeguarded in that his claim had to be met before any dividend could be paid. It was not suggested that the directors had postponed a dividend in order to injure the plaintiff, or that they had acted otherwise than with ordinary prudence. In his view the directors were justified in the course which they took, and the action failed.—*Stewart* v. *Sashalite Ltd.* (1936), 80 Acct. L.R. 85.

DISTINCTION BETWEEN CAPITAL AND INCOME; DEPRECIATION; PROFITS AND DIVISIBLE PROFITS; RESERVES; DIVIDENDS

In the following cases of an omnibus character, the law relating to these matters was considered and expounded. Competent Directors should, however, look at these questions from a financial point of view and adopt a prudent course which will preserve the liquidity of the companies with which they are concerned. By doing so they will find they have kept well within the law and avoided the risk of insolvency which might result from acting merely on strict legal principles.

Drapery Trust Ltd. v. *Drages Ltd.* (1934)

In this case, which is not officially reported, the Trust claimed that the expression "profits available for distribution" included any sum standing to the credit of general reserves, and the balance of profits carried forward from previous years in addition to the actual profit for the year. In other words, the expression "profits available for distribution" included all profits which the defendant company could distribute without acting *ultra vires*. The Court held that on a true construction of the agreement which had been made by the two companies, profits available for distribution in any year meant the profits available after making such reserves as the Directors acting in good faith and in accordance with the Memorandum and Articles of Association thought it desirable to make in the interests of the company.

In the absence of a full report, it is not possible to refer to the agreement or to the Memorandum and Articles, but it affords a guide to the question of "What are profits available for distribution?"

Lee v. *Neuchatel Asphalte Co., Ltd.* (1889), 41 Ch.D. 1

The principal asset of the company consisted of asphalte mines held under a concession. The Articles of the company provided that the Directors need not make a reserve for the replacement or renewal of any concession or property.

An ordinary shareholder brought an action to restrain the company from paying a preference dividend without providing for depreciation in respect of the concession as being a wasting asset. The Court of Appeal decided in favour of the company.

In the course of his judgment, Stirling, J., made the following remarks—

> It may be that in some future year the company will have to set apart a substantial sum to represent depreciation in the value of the concession; but so long as the capital remains intact, and the current receipts exceed the current expenditure, both according to the general law and under the provisions of these particular Articles of Association, it rests entirely with

the shareholders to decide whether the excess shall be divided among them or set apart as a reserve fund for replacing wasting assets, and the Court has no power to interfere with their decision, however foolish or imprudent it may seem to be.

In the Court of Appeal, Lindley, L.J., remarked—

Now we come to consider how the Companies Act is to be applied to the case of a wasting property. If a company is formed to acquire and work a property of a wasting nature, for example, a mine, a quarry, or a patent, the capital expended in acquiring the property may be regarded as sunk and gone, and if the company retains assets sufficient to pay its debts, it appears to me that there is nothing whatever in the Act to prevent any excess of money obtained by working the property over the cost of working it from being divided amongst the shareholders, and this, in my opinion, is true, although some portion of the property itself is sold, and in some sense the capital is thereby diminished. If it is said that such a course involves payment of dividend out of capital, the answer is that the Act nowhere forbids such a payment as is here supposed.

Re Spanish Prospecting Co., Ltd., [1911] 1 Ch. 92

In the absence of any special agreements, profits where the rights of third parties are at stake are the actual profits and need not be the profits as shown by the Profit and Loss Account.

The company had agreed with two employees that they were to receive salaries which they were only entitled to draw "out of profits" arising from the business of the company which might be available for the purpose of paying salaries. The salaries were to be cumulative and payable out of subsequent profits. The company went into liquidation, arrears of salaries being outstanding.

The objects of the company included the purchase and sale of shares. At the date of liquidation certain debentures were in the hands of the company but no value had been put upon them. The debentures were realized by the liquidator and the employees claimed that the proceeds should be regarded as profits out of which the arrears of salary should be paid.

The Court of Appeal reversing the decision of Mr. Justice Swinfen Eady decided that the proceeds should be credited to Profit and Loss Account for the purpose of calculating the salaries.

Fletcher Moulton, L.J., said—

Though there is a wide field for variation of practice in these estimations of profit in the domestic documents of a firm or company, this liberty ceases at once when the rights of third persons intervene.

In the absence of special stipulations to the contrary, "profits," in cases where the right of third parties come in, means actual profits, and they must be calculated as closely as possible in accordance with the fundamental conception, or definition to which I have referred. I would have it clearly understood that these remarks have no bearing upon the vexed question of the fund out of which dividends may legally be paid in limited companies.

This case relates only to the division of profits, but it indicates the importance of using care in the preparation of agreements relating to a share in profits.

CHAPTER XI

LIABILITIES OF AUDITORS

THE object of an audit is set out in Chapter II.

The responsibility of an Auditor to his client, whether a corporation, company, or individual, has been the subject of a number of actions in the Law Courts.

These actions may be brought either under Common Law or under the Companies Act, 1929. There is also a possibility of action being taken under the Larceny Act, 1861, and the Larceny Act of 1916, and the Falsification of Accounts Act, 1875. If a company is carrying on business, action is taken under Common Law; if the company is being wound up, proceedings are usually taken under Section 276 of the Companies Act, 1929, at the instance of the Official Receiver, the liquidator, or any creditor. The Court may be asked to examine into the Auditor's conduct and to make him compensate the company if he be found guilty of negligence by payment of such an amount as the Court thinks just. Prior to the Companies Act, 1929, it was not unusual to find a clause in the Articles of Association indemnifying the Directors and other officers, and also the Auditors, of the company against any damages arising from any act other than from wilful negligence or default. Section 152 of the Companies Act, 1929, declares any provision of this kind to be void, but provides that a company may indemnify any Director, manager, officer or Auditor against any liability incurred in defending an action, whether civil or criminal, in which judgment is given in his favour.

Actions against the Auditor, in cases of this kind, involve a claim for damages for negligence which has caused a loss to his client. There may have been defalcations on the part of Directors or employees, or the Auditor may have failed to detect false statements in the books or in the Balance Sheets and other accounts of the business, which may have involved the improper payment of dividends or commissions.

The full reports of the following cases make instructive reading. It is sufficient to reproduce here short statements of the facts and results and the purport of the judicial pronouncements in each case. The principal cases, arranged for convenience of reference in alphabetical order, are as follows—

Re Allen Craig & Co. (London) Ltd., [1934] Ch. 483

This was a misfeasance summons against the Auditors issued by the Liquidator. The Auditors had made reports to the company

which had never reached the shareholders. It was argued that they were required to make a report to the shareholders pursuant to Section 134 (1) of the Companies Act, 1929. The Judge remarked that there were no means by which the Auditors themselves could convene a general meeting. The Auditors themselves were powerless in the matter. The Judge also said that all the circumstances pointed to the conclusion that the duty of the Auditors, when they had affixed their signature to the report attached or annexed to the Balance Sheet was discharged when they had sent that report to the Secretary of the company. It was the statutory duty of the Secretary or the Directors to convene a general meeting to consider the report. The case against the Auditors was dismissed with costs.

Apfel's Trustee v. *Annan, Dexter & Co.* (1926), *The Accountant*, Vol. LXXV, pp. 286, 687

This action was brought by the trustee of the property of Mrs. Adele Apfel, a bankrupt, against the defendants for alleged negligence and breach of contract. The defendants stated that they were only empowered to prepare income tax returns and not to audit. Inadvertently a bill of charges had been rendered, reading as follows—

Professional services rendered for auditing your Accounts for the eight months ending 31st December, 1922.

On the other hand, a certificate had been given reading as follows—

Prepared from the books of Mrs. Adele Apfel and in accordance therewith.

The Judge, however, found that the defendants had only been employed to prepare accounts for special purposes and the plaintiff's action was dismissed with costs.

In the course of his judgment the Judge said—

As I understand the contention, it is said, and I think truly, that an Auditor who is instructed to make a full audit of business books is responsible not only for getting out such accounts as the books when properly made up appear to show, but is also responsible for ascertaining the true position of the business, whether disclosed properly by the books or not.

Now there are two forms of certificates that professional men in the position of the defendants are in the habit of giving. One is an audit certificate stating that the accounts to which they put their hands reflect the true position of the business dealt with in the accounts. The second is a certificate that, treating the books as made up for what they are worth, the accounts prepared reflect, and only reflect, the position of the business as shown in the books.

Armitage v. *Brewer & Knott* (1932), 87 Acct. 836

In the course of the hearing Mr. Justice Talbot put the duty of Auditors on rather an unpleasant footing when he said—

It is the duty of Auditors to be suspicious. That is what they are there for. If everybody was honest and careful there would be no need for Auditors. . . . He saw there were receipts unstamped. He should have thought that those would have attracted the attention, and provoked the comment, of an Auditor.

He also added that one of the objects of an Auditor was to enable the employer to get rid of a fraudulent servant, and the natural result if one left a fraudulent book-keeper was that frauds would follow.

In his judgment he said—

The documents at the beginning set out that the defendants would vouch all payments with receipts in petty cash, check calculations and additions of all wage sheets, check totals of wage sheets into wages book and check weekly totals, with other detailed provisions, and accountants undertaking duties of that kind could not be heard to excuse themselves on the ground that this or that was a small matter; they undertook a rigorous check, and they did so because that was what their client wanted.

The case was brought by Mr. Armitage against the defendants claiming damages for alleged negligence in auditing the plaintiff's books. Judgment was entered for the plaintiffs.

Astrachan Steamship Company and others v. *Harmood-Banner and others* (1900), Acct. L.R. 49. (Lancashire Chancery Court.)

This was a case concerning five single-ship companies, each company being managed, without Directors, by a manager. As there were no Directors, the only safeguard of the shareholders was the audit. The manager presented the accounts of the various companies for audit at different times, and by keeping in hand a sum of money contrived to balance each company's accounts in turn. As Counsel put it, the sum of money went round while it lasted, but it was first under one thimble and then under another. Expert witnesses for the plaintiffs agreed that the state of things palpable on the face of the books of the Astrachan Company called on the defendants (1) to demand from the manager his special authority for borrowing the moneys of the company; or (2) to report the position to the shareholders; or (3) to have altered the item in the Balance Sheet "cash in manager's hands" to "cash borrowed by manager at 4 per cent interest."

The case was settled out of Court, the defendants paying a certain sum of money in settlement.

His Honour the Vice-Chancellor said—

The only thing necessary for me to say is that there is no imputation on the honour or capacity of the Auditors, but it is perfectly obvious that the

manager had been manipulating the assets, and they were, like other people, taken in by him.

The Calne Gas Co. v. *Curtis*, 59 Acct. L.R. 17,
The Gas World, 31st July, 1918

This case was in respect of the liability of an Auditor for damages caused by his failure to discover the frauds of a former secretary of the plaintiff company. The books had been badly kept and for ten years the Secretary committed what is known as the "snowball fraud." The audit fee was five guineas, but the small amount of the fee cannot be pleaded in defence.

One allegation was that the defendant had not tested the lump sum receipts from slot meters by reference to any books and did not know that such books were kept. Evidence was given by well-known chartered accountants both for the plaintiff and for the defendant. Judgment was given for the defendant with costs.

Salter, J., said—

It was important to guard oneself against approaching the matter in the light of subsequent knowledge. Defendant had no cause to suspect the secretary outside the books. Whether the books ought to have put him on suspicion was the main matter he (the Judge) had to determine, but it was important to approach the matter from the point of view that this was an ordinary periodical audit of the books of a trusted and apparently respectable man whom there was no cause to suspect. The book-keeping methods of the company were old-fashioned and the writing up of the books was in arrear.

It was clear that the mere fact that a fraud was not discovered in the course of an audit was not conclusive evidence of negligence in the conduct of the audit. But where an Auditor in fact issued a false certificate in the sense of an incorrect certificate, His Lordship thought it rested upon the Auditor to show that the belief upon which the certificate was based had not been the result of any lack of proper care or proper skill on his part in conducting the audit.

On the whole his Lordship came to the conclusion that as regards industry and care, the defendant had brought to bear at least a fair and average standard, and as regards competence and skill, the evidence satisfied him that the defendant did not fall below a fair average of competence and ability which he was bound by law to bring to the conduct of this work. He therefore gave judgment for the defendant with costs.

Re City Equitable Fire Insurance Co., Ltd., [1925] Ch. 407

In this case the Official Receiver as liquidator sued the Directors and Auditors in respect of alleged misfeasance.

The following claims were made against the Auditors—

1. That in the Balance Sheets sums due from Ellis & Co. (stockbrokers) and Mansell (the company's General Manager) were misdescribed by being included under "Loans at call or

short notice" or "Loans." Part of the debt of Ellis & Co. was described as "Cash at bank and in hand."

2. That in fact the sums actually due from Ellis & Co. were larger than were so included.

3. That certain of the company's securities were in the custody of Ellis & Co. and the Auditors failed to detect and report to the shareholders that these had been pledged by that firm to third parties.

In the course of his judgment, Mr. Justice Romer made the following observations—

If in the course of these long and arduous audits the Auditor has in even one instance fallen short of the strict duty of an Auditor, he cannot, I apprehend, be excused merely because in general he displayed the highest degree of care and skill.

There was a misdescription, but I should hesitate long before holding the Auditor to be guilty of negligence in this respect. I need not, however, pursue this matter further because, even if the misdescription did amount to negligence, it caused no damage to the company.

For an Auditor is not in my judgment ever justified in omitting to make personal inspection of securities that are in the custody of a person or company with whom it is not proper that they should be left.

I am convinced that throughout the audits that he conducted he honestly and carefully discharged what he conceived to be the whole of his duty to the company. If in certain matters he fell short of his real duty, it was because, in all good faith, he held a mistaken belief as to what that duty was. As against him and his partner, the application of the Official Receiver must accordingly be dismissed.

In the Court of Appeal Mr. Justice Romer's judgment was upheld.

Lord Justice Sargant described the duty of an Auditor as "verification and not detection."

Lord Justice Warrington said: " The duty of an Auditor is to verify the facts which it is proposed to state in the Balance Sheet and to verify them using ordinary and reasonable care and skill."

As a matter of fact, the Auditors were protected by an Article of the company indemnifying the Directors, Auditors and officers of the company against damages incurred in carrying out their duties unless incurred by wilful neglect.

Under Section 152 of the Companies Act, 1929, a protective Article of this nature is now null and void, but see Section 372 of the Act reproduced on page 161.

Thomas v. *The Corporation of Devonport*, [1900] 1 Q.B. 16

Held that an elected Auditor cannot claim remuneration out of the Borough Fund, but is entitled to reasonable remuneration as Auditor of an Urban Sanitary Authority. This case is interesting because of the following statements made by Lord Russell of Killowen—

I do not subscribe to the doctrine that his (the Auditor's) sole duty is to see whether there are vouchers, apparently formal and regular, justifying each of the items in respect of which the authority seeks to get credit upon the accounts put before the Auditors for audit. I think that is an incomplete and imperfect view of the duties of the Auditor. I think an Auditor is not only entitled, but justified and bound to go further than that, and, by fair and reasonable examination of the vouchers, to see that there are not amongst the payments so made payments which are not authorized by the duty of the authority, or in any other way illegal or improper. If he discovers that any such improper or illegal payments appear to have been made, his duty will certainly be to make it public by reporting to the authority itself and the burgesses who created that authority.

The following cases do not relate to Auditors, but throw some light on the interpretation of negligence—

Blyth v. *Birmingham Water Works Co.* (1856), 11 Exch. 781

Negligence was defined as "the omission to do something which a reasonable man, guided by those considerations which ordinarily regulate the conduct of human affairs, would do, or doing something which a prudent and reasonable man would not do." No definition of a reasonable man is given. That would be a question for a jury.

Grill v. *General Iron and Screw Colliery Co.* (1866), L.R. 1 C.P. 612

Negligence was defined as "the absence of such care as it was the duty of the defendant to use."

Wilson v. *Brett* (1843), 11 M. & W. 113

On the question of gross negligence the Judge said: "I can see no difference between negligence and gross negligence; it is the same thing with the addition of a vituperative epithet."

Re Dumbell's Banking Company Ltd. (1900), Acct. L.R. 181

A criminal prosecution of Directors and Auditors for the issue of false Balance Sheets under Manx Criminal Code, 1872, Section 221. This case is reported very fully in *The Accountant*, 1900, L.R. 181, and disclosed an extraordinary state of affairs. The liquidator giving evidence as to the accounts was asked by the Attorney-General: "Is it apparent to anybody on the face of these accounts that they are rotten?" He replied: "I have not the slightest hesitation in saying so." The jury found all the defendants guilty, one of the Auditors in a minor degree.

Fox & Son v. *Morrish Grant & Co.* (1918), 35 T.L.R. 126

It was held that an accountant employed to check books and prepare a Balance Sheet should agree the Cash Book with the Bank Pass Book or inform his client that he has not done so.

The case calls attention to the desirability in such matters of having a clear arrangement in writing defining the duties undertaken by the accountant. In this instance the defendants acted as accountants and not as auditors.

Re Arthur Francis, Ltd. (1911), 44 Acct. L.R. 61

In this case the liquidator issued a summons against a firm of Auditors asking for an order for the handing over of certain books which the Auditors had retained as there were fees owing to them for work done upon the books.

The respondents contended that they had a lien on the books, but he (counsel) submitted that the directors had no power to give any such lien, because, under the Articles of Association, the books were to be kept at the company's office, and therefore they could not be subject to any lien. The only book he wanted was the Private Ledger, and he asked his Lordship to make the necessary order for the respondents to deliver it up.

The Judge observed that he did not think the respondents could be allowed to embarrass the winding-up of the company by keeping the books. He should have thought that the Private Ledger was a most essential book for the purposes of the liquidation.

His Lordship made an order that the books should be produced, without prejudice to the lien (if any) of the respondents.

Arthur E. Green & Co. v. *The Central Advance & Discount Corporation* (1920), 63 Acct. L.R. 1

Held that in certain circumstances Auditors may be held negligent in accepting schedules of bad debts supplied to them by the Managing Director. This was an action brought by the Auditors for recovery of fees. There was a counterclaim by the defendants based on allegations of negligence in the preparation of the accounts. The Judge said the conclusion he had come to was that the Auditors having made inquiries had received no satisfactory explanations. Judgment was given for the plaintiffs for £157 10s. and for the defendants on the counterclaim for £613 14s. 11d.

Re Joseph Hargreaves, [1900] 1 Ch. 347

Held that an Auditor who refuses to certify the accounts of a company cannot be held liable because no correct accounts were submitted to the shareholders. It was unsuccessfully contended by the plaintiff that the Auditor should either have brought the matter to the knowledge of the shareholders or should have resigned.

Harmer v. *Cornelius* (1858), 5 C.B.N.S. 236

The public profession of an act is a representation and undertaking to all the world that the professor possesses the requisite ability and skill.

As the Romans put it, *imperitia culpae adnumeratur* (inexperience renders you liable).

A treatise by Sir Ernest Pollock contains the following statement—

Whoever takes on himself to exercise a craft holds himself out as possessing at least the common skill of that craft and is answerable accordingly. If he fails, it is no excuse that he did the best he, being unskilled, actually could.

Metropolitan Railway v. *Jackson* (1878), 3 App. Cas. 193

The judge has a certain duty to discharge, and the jurors have another and a different duty. The judge has to say whether any facts have been established by evidence from which negligence may be reasonably inferred; the jurors have to say whether from those facts, when submitted to them, negligence ought to be inferred.

In a case of this nature, the judge might withdraw the case from the jury on the ground that there was no evidence from which the jury could infer negligence.

Hoale and Others v. *Tingey* (1926), 74 Acct. 518

This was an action by an accountant for fees due. There was a counterclaim for damages for retention of the defendant's books and papers. The claim for fees was upheld. Mr. Justice Roche decided that the right to a lien existed and the counterclaim was dismissed.

Irish Woollen Company, Ltd. v. *Tyson and Others*, (1900), Acct. L.R. 13, Irish Appeal Court

This was an appeal by the Auditor against the decision given by the Master of the Rolls (Irish Court of Chancery, reported in *The Accountant* Law Reports, 1900). The appeal was dismissed. The judgment should be read in full, but the following extracts are of interest to accountants.

The Auditor seems to have done little of the actual work himself, and the evidence varies as to the nature of the supervision which he gave to it; the investigation of the books he deputed to his assistants and it must be on the faith of their representations that he certified the Balance Sheets. I presume this course is not unusual, and that an accountant with a large business is not supposed to do everything himself. The Auditor is bound to give reasonable care and skill, but this can also be exercised by his deputy. I do not think there is anything to be gained by considering in the abstract the duties of an Auditor of a joint stock company. He is entitled to see the company's books and the materials for their books, and also to ask for explanations. *But he is not called on to seek for knowledge outside the company, or to communicate with customers or creditors.* He is not an insurer against fraud or error; and if fraud is alleged it must be shown with precision the acts of negligence for which he is said to be responsible.

There was certainly no duty cast on the Auditor to take stock. What he did was to have the calculations checked in his office, and this was done with proper care.

Now dealing with "Sundry Creditors"; here evidently there is a fraud, and a curious thing is that no one seemed to have derived any benefit from the fraud. Dealing with the invoices, the learned Judge detailed the practice in connexion with the statements of accounts being laid before the meeting, and said the Ledger was used for the purchases made and for the payments on account thereof.

The creditors' accounts in the Ledger did not show all the goods purchased up to the time of the audit, nor could the Auditor discover the omissions on account of many of the invoices being either "suppressed" or not put into the book until at a later date—a process described as "carrying over."

It seems strange that a system of fraud so long continued, and for so extensive a period, was never detected by the Auditor. Once or twice he noticed something, and the explanation that was given was "that the goods were not taken into stock." The question is, was it negligent not to have seen this?

There is no doubt that both the suppression and carrying over of invoices would have been detected if the Auditor had *called for the creditors' statements of accounts upon which payment was ordered*, and compared them with the Ledger. I should have thought this was part of the Auditor's duty for many reasons; but all the accountants examined, except Mr. Southworth, stated that this course is never taken unless there is something to arouse suspicion.

Mr. Pixley, the eminent London accountant, says it could not well be done except in the case of a very small concern.

Re The Kingston Cotton Mill Co., Ltd., [1896] 1 Ch. 6

Held that in the absence of suspicious circumstances, an Auditor is not guilty of negligence who relies upon the statements made by trusted officers of the company.

In this case there had been a systematic over-valuation of stocks on hand. As a result dividends had been paid out of capital. The Auditors accepted the value of the stock-in-trade as appearing in the Stock Books and summaries so as to show the total value. The summary was signed by the Manager and entered in the Balance Sheet with the note "as per Manager's certificate." Lindley, L.J., said—

I protest, however, against the notion that an Auditor is bound to be suspicious, as distinguished from being reasonably careful. To substitute the one expression for the other may easily lead to serious error.

It is no part of an Auditor's duty to take stock. No one contends that it is. He must rely on other people for details of the stock-in-trade in hand. In the case of a cotton mill he must rely on some skilled person for the materials necessary to enable him to enter the stock-in-trade at its proper value in the Balance Sheet.

Can it be truly said that the Auditors were wanting in reasonable care in not thinking it necessary to test the managing director's returns? I cannot bring myself to think they were, nor do I think that any jury of business men would take a different view. It is not sufficient to say that the frauds must have been detected if the entries in the books had been

put together in a way which never occurred to anyone before suspicion was aroused. The question is whether, no suspicion of anything wrong being entertained, there was a want of reasonable care on the part of the Auditors in relying on the returns made by a competent and trusted expert relating to matters on which information from such a person was essential. I cannot think there was.

Lopes, L.J., in the course of his judgment made the following remarks—

It is the duty of an Auditor to bring to bear on the work he has to perform that skill, care, and caution which a reasonably competent, careful, and cautious Auditor would use. What is reasonable skill, care, and caution must depend on the particular circumstances of each case. An Auditor is not bound to be a detective, or as was said to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watch-dog, but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion he should probe it to the bottom, but in the absence of anything of that kind, he is only bound to be reasonably cautious and careful.

The duties of Auditors must not be rendered too onerous. Their work is responsible and laborious, and the remuneration moderate. I should be sorry to see the liability of Auditors extended any further than *Re The London and General Bank*. Indeed, I only assented to that decision on account of the inconsistency of the statement made to the Directors with the Balance Sheet certified by the Auditors and presented to the shareholders. This satisfied my mind that the Auditors deliberately concealed that from the shareholders which they had communicated to the Directors. It would be difficult to say this was not a breach of duty. Auditors must not be made liable for not tracking out ingenious and carefully-laid schemes of fraud, when there is nothing to arouse their suspicion and when those frauds are perpetrated by tried servants of the company and are undetected for years by the Directors. So to hold would make the position of an Auditor intolerable.

There can be little doubt that an action for libel will not lie in respect of statements used in the Report of an Auditor, if made in a *bona fide* manner. A company whose head office was at Manchester, with factories in Egypt, received from their Manager in Egypt accounts of purchases made, quantity of cotton and oil in stock, and the expenses incurred. In the Revenue Account submitted to the Auditors, the last item entered on one side of the Account was "Deficiency in Stock, £1306 1s. 7d." It was explained to the Auditors that this last item, though entered as deficiency, was, in truth, only a depreciation in the value of the stock, for which the Manager was not answerable; but the Auditors, notwithstanding, affixed the following Certificate—

We certify that the Accounts as above stated are correct. Shareholders will observe that there is a charge of £1306 1s. 7d. for deficiency of Stock, which the Manager is responsible for. His Accounts have been badly kept, and have been rendered to us very irregularly.

This report, together with that of the Directors, was submitted to the ordinary general meeting of the shareholders of the company, according to the usual practice, and it was resolved by the meeting that the Report should be printed and sent to the shareholders. The Reports (including the above statement) were accordingly sent to a printer, printed and circulated among the shareholders, and used at an adjourned meeting of the shareholders. The Manager brought an action for libel against the company, when it was held that, as it was the duty of the Directors to communicate the Report of the Auditors to the shareholders, and it was for the interest of all the shareholders to be informed of the Report, the printing and publication of the Reports were *prima facie* privileged, and that there was no evidence of expressed malice for the jury.—*Lawless* v. *Anglo-Egyptian Cotton and Oil Co.* (1843), 4 Q.B. 262.

Leeds Estate Building and Investment Co. v. *Shepherd* (1887), 36 Ch.D. 787

In this case it was to the financial advantage of the Directors and the Secretary to make it appear that the state of the company was better than actually was the case. Proceedings for negligence were taken out under the following Article: " No dividends shall be payable except out of the profits arising from the business of the company." It appears that dividends were paid out of capital.

The Judge said: "It was, in my opinion, the duty of the Auditor not to confine himself merely to the task of verifying the arithmetical accuracy of the Balance Sheet, but to inquire into its substantial accuracy and to ascertain that it contained the particulars specified in the Articles of Association (and consequently a proper Income and Expenditure Account) and was properly drawn up so as to contain a true and correct representation of the state of the company's affairs."

The Auditor was held liable for damages, but pleaded the Statute of Limitations for certain years. The plaintiffs admitted the validity of the plea without arguing the question.

Re The Liverpool and Wigan Supply Association Ltd. (1907), Acct. L.R. 4. Liverpool Court of Bankruptcy

The Court was moved for an Order on the Auditor—

To contribute such sum of money to the assets as to this Court may seem fit and proper, by way of compensation in respect of his misfeasance and neglect of duty as Auditor of the company, for that he being Auditor of the company did make Balance Sheets for the half-years ending the 30th day of June, 1905, and the 31st day of December, 1905, which were incorrect and misleading, and that the said Auditor did not use reasonable care and skill in the making and preparing of such Balance Sheets, and neglected his duties as Auditor of the said company, and thereby caused

loss of assets, and damage to the shareholders and creditors of the said company.

The judgment was as follows—

In this case I think that the Auditor was negligent as an Auditor in the sense that he relied on statements made to him by the Directors, and did not put in his certificate the fact that he was relying on the statements of the Directors. The Auditor did not disclose that there was no Cash Book, and, if it were material in this case to say so, I think the Auditor ought to have disclosed it. I don't think he ought to have accepted the statements of a Director as to the taking of stock, and the Balance Sheets should have shown the position of the company on the dates they purport to have shown the position. But none of these acts appears to me to have diminished the assets of the company as such. What may have happened is that the creditors went on dealing with the company longer than they otherwise would have done, but I have no evidence before me that satisfies me that even that was the case, and with respect to creditors this is not the proper form of procedure, if they have any remedy at all. I think Mr. Courthope Wilson is right that under this form of proceedings it must be established that there has been breach of duty that has resulted in some actual diminution of the assets of the company. And in regard to the statement as to the book debts, there is no evidence that at any time those could have been collected, but in fact the report shows to the contrary. In regard to the amount that ought to have been to the credit of the company at the bank, that is accounted for in the statement as to the extent of the company's assets and is not anything that diminishes the company's assets, consequently no evidence has been brought before me to show that the assets of the company have been diminished by anything the Auditor has done, and these proceedings, I think, must fail."

The Auditor was not given his costs.

Re The London and General Bank Ltd. (*No.* 2),
[1895] 2 Ch. 673

Held that an Auditor is guilty of misfeasance who, when dissatisfied with the accounts of a company, does not plainly draw attention to the grounds for his dissatisfaction in his report.

This was an appeal by one of the Auditors against a judgment by Vaughan Williams by which the Auditors were declared liable for the payment by the company of certain dividends out of capital, it having been decided by the Court of Appeal in the previous action in connexion with this liquidation that the Auditor of a limited company is an officer of the company and therefore liable to misfeasance proceedings. The Auditor had neglected to bring to the notice of the shareholders that the assets shown in the Balance Sheet of the company were over-valued leading to a payment of dividends out of capital. Lindley, L.J., said—

It is no part of an Auditor's duty to give advice either to directors or shareholders as to what they ought to do. . . . An Auditor has nothing to do with the prudence or imprudence of making loans with or without security. It is nothing to him whether the business of a company is being conducted prudently or imprudently, profitably or unprofitably; it is nothing to him whether dividends are properly or improperly declared,

provided he discharges his own duty to the shareholders. His business is to ascertain and state the true financial position of the company at the time of the audit, and his duty is confined to that. But then comes the question: How is he to ascertain such position? The answer is: By examining the books of the company. But he does not discharge his duty by doing this without inquiry and without taking any trouble to see that the books of the company themselves show the company's true position. He must take reasonable care to ascertain that they do. Unless he does this, his duty will be worse than a farce. Assuming the books to be so kept as to show the true position of the company, the Auditor has to frame a Balance Sheet showing that position according to the books, and to certify that the Balance Sheet presented is correct in that sense. But his first duty is to examine the books, not merely for the purpose of ascertaining what they do show, but also for the purpose of satisfying himself that they show the true financial position of the company. This is quite in accordance with the decision of Mr. Justice Stirling in *The Leeds Estate and Investment Co.* v. *Shepherd* (1887), 36 Ch.D. 787. An Auditor, however, is not bound to do more than exercise reasonable care and skill in making inquiries and investigations. He is not an insurer; he does not guarantee that the books do correctly show the true position of the company's affairs; he does not guarantee that his Balance Sheet is accurate according to the books of the company. If he did he would be responsible for an error on his part, even if he were himself deceived, without any want of reasonable care on his part—say, by the fraudulent concealment of a book from him. His obligation is not so onerous as this.

Such I take to be the duty of the Auditor; he must be honest—that is, he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true.

What is reasonable care in any particular case must depend upon the circumstances of that case. Where there is nothing to excite suspicion, very little inquiry will be reasonable and sufficient; and in practice, I believe, business men select a few cases haphazard, see that they are right, and assume that others like them are correct also. Where suspicion is aroused more care is obviously necessary, but still an Auditor is not bound to exercise more than reasonable care and skill even in a case of suspicion; and he is perfectly justified in acting on the opinion of an expert where special knowledge is required.

A person whose duty it is to convey information to others does not discharge that duty by simply giving them so much information as is calculated to induce them, or some of them, to ask for more. Information and means of information are by no means equivalent terms.

The Articles of Association cannot absolve the Auditors from any obligation imposed upon them by the statute.

The words "as shown by the books of the company" seem to me to be introduced to relieve the Auditors from any responsibility as to affairs of the company kept out of the books and concealed from them, but not to confine it to a mere statement of the correspondence of the Balance Sheet with the entries in the books. Now, a full and fair Balance Sheet must be such a Balance Sheet as to convey a truthful statement as to the company's position. It must not conceal any known cause of weakness in the financial position, or suggest anything which cannot be supported as fairly correct in a business point of view.

In the last-mentioned report is contained for the first time a statement, "The value of the assets as shown on the Balance Sheet is dependent on realization."

Great stress has been laid on this by counsel for the appellants. They

argue that it was sufficient to put members upon inquiry, and that from the course taken at the trial they were debarred from giving the evidence of experts as to the importance and signification of this. I may at once say that it was the duty of the Auditors to convey in direct and express terms to the members any information which they thought proper to be communicated, that the words of the statement are perfectly clear in their meaning, but also entirely unimportant, amounting to a mere truism, and that no evidence of experts would have been of the slightest use for the purpose of giving them a greater importance or signification than they possessed in themselves, even if such evidence were admissible.

There was a strong and growing feeling of dissatisfaction in the mind of the Auditor at the state of the affairs of the bank as shown by the books, and I find no sufficient communication of the facts causing this dissatisfaction in the reports. The Balance Sheets when examined do not in my opinion fulfil the statutory requirements of being full and fair Balance Sheets, and they are not properly drawn up so as to exhibit a true and correct view of the state of the company's affairs as shown by the books of the company.

It is no part of the Auditors' duty to consider what is good or what is bad policy. They have only to examine into facts and see that the members have their opinion as to the Balance Sheet showing the state of affairs of the company.

In short, the Balance Sheet, as it stands, would have given no hint to any ordinary reader of the critical position arising either from the locking-up of capital or from the doubtful nature of many of the debts entered at their full value. In reporting this Balance Sheet without explanation, the Auditors were, in my judgment, guilty of a misfeasance within the meaning of the 10th Section of the Act of 1890, as charged in the summons, and were in this case, at any rate, thoroughly alive to the unsatisfactory state of the affairs of the bank as shown by the books.

The Auditor was ordered to pay the amount of a dividend, wrongfully paid, with interest.

London Oil Storage Co., Ltd. v. *Seear, Hasluck & Co.*, (1904) 31 Acct. L.R. 1

In this case the Petty Cash balance had increased from £21 in 1897 to £796 in 1902, when it was discovered that the Petty Cash in hand was only £30. Action was taken against the Auditors for alleged negligence in auditing the accounts. The Auditors denied that they had been negligent and said that the alleged loss of £760 was due to negligence on the part of the Directors of the company for entrusting so much money to their cashier. The jury found that the Auditors had committed a breach of trust, but assessed the damages at £5 5s. in view of the fact that the Directors had been guilty of gross negligence.

The Lord Chief Justice summing up to the jury said that they had not to consider whether the Auditor had been sufficiently remunerated or not. Nor could the Auditor shelter himself behind negligence on the part of Directors, as he was there to protect the shareholders. If, by neglect of his duties, he caused damage to the company, he was liable. He should have thought that *prima*

facie it would be the duty of an Auditor to check a balance of cash in hand, but how that should be done was another matter; it might be that a certificate from the secretary would be a sufficient voucher. An Auditor was not bound to criticize the policy of the Directors, and the mere increase in the cash balance did not seem in itself to be a suspicious circumstance. If it did not arouse the suspicion of the Directors it seemed rather hard to say that it should have aroused the suspicion of the Auditor.

The conduct of the Directors is no answer to any breach of duty on the part of the defendant, but it is a circumstance which you must take into consideration, because if you are of opinion that the loss was occasioned by a man stealing the money in consequence of there being a want of proper control over him, then the fact of there being a breach of duty by the Auditors is what the lawyers call a *causa causans*, which contributed to but would not be the cause of the loss.

G. J. McCaul & Co. v. *McLean & Co.* (1907), 37 Acct. 104

The plaintiffs took action against the defendant, the Auditor, alleging that it was through his neglect that they had lost money by defalcations of an employee. The defence was that by agreement with a previous partner, the audit undertaken was agreed to be of a limited nature. It was admitted the defendant had taken no steps to bring the arrangement with the previous partner to the knowledge of subsequent partners.

The action was, however, settled and no decision on the point at issue was arrived at.

Maritime Insurance Co., Ltd. v. *William Fortune & Son,* (1931), Acct. L.R. 44–45

In this case the plaintiffs claimed from the defendants damages for alleged breach of duty in certifying the accounts of the branch office of the plaintiff company and failing to discover defalcations carried out by an employee. The defendants denied negligence, pleading that they were not employed as Auditors but only to see that certain monthly returns were correctly made out from the books kept by the company's servant.

The Judge in his summing up said that in his view the employment of the defendants was limited to examining the books, seeing that they corresponded with the books that had to be kept and in that sense seeing that they were adequately kept and seeing that they were adequately summarized in the return to head office. Of course, it would have been the duty of the defendants to report on the matter if anything suspicious had appeared in the books. In his view there was nothing which excited or ought to have excited their suspicion. They were not in possession of

material which would have enabled them to know whether the business of the branch was being satisfactorily conducted or whether the books of account truly showed the state of affairs of the branch. He thought that the misappropriation of money was not detected before it was, because there was no system in vogue by which the cash received could be checked. The acts and omissions which brought about the trouble were not the acts and omissions of the defendants, and they had been guilty of no breach of duty or negligence.

The counting of the cash would have been useless in the circumstances, and there was nothing which required them to go behind the books of account and examine the paying-in book. That was only done in cases where there was reason to suspect inaccuracy or dishonesty and the defendants had no reason to suspect that here.

Judgment was accordingly entered for the defendants with costs.

Martin v. *Isitt* (1898), Acct. L.R. 41

This action was brought against Messrs. Isitt & Co., Chartered Accountants, for alleged negligence inasmuch as they had not compared the Cash Book with the Bank Pass Book. A comparison of the two books would have shown that a clerk was embezzling the funds of the plaintiffs. The embezzlement was eventually discovered by Messrs. Isitt & Co., but the plaintiffs claimed that they should have discovered it earlier. The defendants contended that they were not acting as Auditors, but were only employed to attend monthly and check the books. They also said that they were hampered by the condition of the books and much delay in getting answers to the many queries they had to raise.

The case was settled out of Court. It was agreed that the defendants had not been negligent or unskilful in the way in which they had done their work, and the plaintiffs confined their claim to a breach of contract by the defendants inasmuch as they had not attended monthly. The Lord Russell of Killowen, C.J., said that as he understood the case as placed before him, no allegation of negligence or unskilfulness was now made, but it was urged that the defendants should have attended somewhat earlier than they actually did; that was a question to be tried, but he thought the action of the parties in arranging the matter to be very proper.

New Oriental Bank Case

In this case, which is not reported, Vaughan-Williams, J., said—

It is not for an Auditor to consider the *bona fides* of Directors, but to deal with the books of the company and with commercial details and figures, not to consider the honesty of its officers.

Note. This is not consistent with the leading decisions as to the attitude which Auditors should adopt.

As to how far the Auditors are the agents of the shareholders, Turner, L.J., said, with respect to fraudulent representations made by the Directors of a company as to its position, "There were Auditors of this company appointed by the shareholders. These Auditors were, within the scope of their duty, at least as much the agents of the shareholders as the Directors were, and the false and fraudulent representations were discoverable by them."—*Nicol's Case, re Royal British Bank* (1859), 3 De G. & J. 387, 441.

Pendleburys Ltd. v. *Ellis Green & Co.* (1936), 80 Acct. L.R. 39

This was an action against the Auditors for alleged negligence or breach of duty. The case is noteworthy because of remarks made by Mr. Justice Swift in giving judgment for the defendants. His Lordship said that when one considered the attitude an Auditor had towards a company, one had also to bear in mind what the constitution of that company was. It was all very well to say that an Auditor was there to protect the shareholders. He was there to see the shareholders got a true representation of the finances of the company as disclosed by the books of the company.

Dealing with the matter as a matter of common sense and in deciding whether reasonable care had been taken or not, the Auditor was entitled to consider such a question as this: Is this company one which has 600 or 700 shareholders to whom I am vouching this information, or is it a company with only three shareholders who happen to be three Directors and the three debenture-holders in the company? It seemed to him it must make a material difference whether he was criticizing it to the three men who, in fact, held every pecuniary interest of the company, or whether he was criticizing it to a large body of outside people who were depending on him to watch the directors and see what they were doing. He was quite satisfied that on more than one occasion the fact that there was no internal check on the cash receipts was brought to the notice of one or other of the two Pendleburys he had seen before him.

The evidence given by Mr. Elliott, an accountant, called for the plaintiff, illustrated the difference between an accountant as an investigator and an accountant who was an auditor. Mr. Elliott was brought in as a detective.

Re Bolivia Exploration Syndicate Ltd., [1914] 1 Ch. 139

"Auditors are *prima facie* responsible for *ultra vires* payments made on the faith of their Balance Sheet, but whether and to what extent they are responsible for not discovering or calling

attention to the illegality of payments made prior to the audit must depend on the special circumstances of each case." It was held in this case that they were not liable.

This was a misfeasance summons. No order was made against the Auditors, but having regard to the general manner in which the audit had been conducted, the summons against the Auditors was dismissed without costs.

R. v. *Kylsant*, [1932] 1 K.B. 442

This action brought against the Auditor under Section 84 of the Larceny Act, 1861, was dismissed. In his summing up Mr. Justice Wright made the following interesting statements regarding reserves—

We have heard a great deal about the keeping of secret reserves, and we have heard a great deal about the commercial troubles which may flow from that practice. We have heard a great deal about what is often done in practice, and it may be reasonably and properly done, but the question may arise some day, and possibly will arise, in some appropriate proceeding in order to find out and elucidate these very special matters. It was said by a very learned judge on one occasion, by way of observation and not by judgment, that a company, that is to say the shareholders, could not complain if the position of the finances of the company was better than the accounts disclosed. That has been quoted from time to time as a justification for this method of keeping reserves secret. But there may be very great evils if those who have the control and management of the companies, and who control and manage companies for the benefit of the shareholders who entrust their moneys to companies, have very large portions of the company's assets left in the secret disposition of the managing authority. It may work very well in many cases; no doubt it does. It is a practice which is being followed, no doubt, by many concerns of the highest standing. On the other hand, it may be the subject of almost intolerable abuse. Such a system may be used to cover up negligence, irregularities, and almost breaches of faith. It is said to be a matter of domestic concern between the company and the shareholders, but if shareholders do not know and cannot know what the position is, how can they form any view about it at all? How can they consider whether it is something which they are satisfied with or which they are not satisfied with?

It is a little astounding, and one cannot help wondering whether those who manage big companies do not forget sometimes that the body of Directors of a company are the agents and the trustees of the shareholders, that they owe them full information, subject to proper and reasonable commercial necessity, and it is their interests that they have to study. They are not to regard the shareholders as sheep, who may look up if they are not fed; they are the people whose money they are using, and it is to be remembered that a joint-stock company is a creation of law. A joint-stock company has the enormous advantage of limited liability, and the legislature has intended, it seems to me, although by halting steps, to secure that those who enjoy those privileges of limited liability and who control and manage joint-stock companies should be subject to some condition as to publishing their accounts, at least to the shareholders and at least to those who are entitled to be summoned to general meetings.

It may be said that that does not in terms prohibit the creation of any reserve which is not shown specifically on the Balance Sheet, and it may

be said that in a matter of domestic concern like the keeping of reserves by appropriate regulations the shareholders may agree to a reserve being accumulated, the exact amount of which is not specified in the Balance Sheet or the Profit and Loss Account. That is a question which, no doubt, will require very careful consideration in some future case, but it does appear to me, as at present advised, that the terms of the sections which I have read cannot possibly justify the omission of any amount of any reserve from the Balance Sheet and the Profit and Loss Account altogether. There may be some justification for the maintenance of an undisclosed or secret reserve, if the fact that there was such a reserve was clearly specified somewhere in the report, so that the shareholders could know, and if the majority of them desired to insist on its disclosure and its utilization they could do so. However that may be, it is clearly the intention of these sections that the accounts of companies in future should be published with greater particularity and with greater information to the shareholders.

The law does not impose an impossible burden on Auditors; it does not make them insurers; it does not require of them skill and vigilance which is beyond their power; but it does require them to report, and to report on the accounts would certainly include a very careful investigation of the Profit and Loss Account as one of the accounts, even if it is not expressly covered in the certificate which is generally accepted as a complete report. Then they have to give a certificate as to whether in their opinion the Balance Sheet referred to in the report is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs according to the best of their information and the explanations given to them. Now, if the account on which the dividends are being paid, or if the account on which the current expenses of the company are being met, is being fed by undisclosed reserves, it seems to me very difficult to see how the Auditor can discharge his duty of giving a true and correct view of the state of the company's affairs without mentioning and drawing attention to this fact, which may be of the most vital importance, as indicating the state of the company's affairs. No doubt an Auditor, in his very delicate and difficult duties, must use a certain amount of discretion, but, whatever discretion he may feel that he is justified in exercising within the limits of what is reasonable, he must remember that he is under a statutory duty, and that he may come under the penalties of the law if he fails in that duty, at least in specific ways which I need not trouble about at this moment.

An Auditor is not concerned with questions of policy, and it is not for him to say whether a dividend is properly or improperly declared, but, if he sees on the accounts there is something in the accounts to which he ought to draw the attention of the shareholders, it is his duty to do so, and either he should not sign the certificate at all or he should sign it with some qualification such as the circumstances require.

The document as a whole may be false, not because of what it states, but because of what it does not state, because of what it implies.

I do not gather now that there is any real question as to the general accuracy of the view that a very heavy or a very long protracted utilization of secret reserves, in order to keep the company going, is a serious matter which, quite apart from anything I have said about the general law, ought to be disclosed, on any view of the position, to the company.

Then you will consider this question, whether the essence of the matter is simply this, that the shareholders ought to have been told that the company was being kept going by means other than current earnings.

On the other hand, it is pointed out that the amount drawn from taxation reserves which figures under the word "Adjustment" is a very heavy amount indeed—£550,000—and it is said, in view of all the circumstances,

to make that anything but a misleading document, in view of the large amount drawn from reserves in proportion to all these other figures, that ought to have been clearly and specifically indicated, so that the true position of the company could have been disclosed to the shareholders; and that in view of the fact that it ought to have been disclosed, and that the accountant signed his certificate, which may be is only limited to the Balance Sheet, but which is generally understood to refer to the Profit and Loss Account, which would be incorporated in the Balance Sheet—in view of the fact that he signed the certificate, it is said, and it is for you to consider, that this is not anything other than a written statement, false in a material respect, because it conceals the true position of the company in that year from the shareholders, who are entitled to be told, and to whom this report is addressed.

In the case of the Auditor, it is obvious enough that in the year 1926, when the accounts of 1925 were being dealt with, he was not satisfied with the position, because he thought that some words ought to be added to intimate to the shareholders that the moneys which we know were being used in order to produce the balance which appears. That being so, he thought, as indeed he has admitted, that without some qualification or another he ought not to give the certificate, and the qualification which he suggested, and which he put in, was those words, which you must all be tired of hearing, "Adjustment of taxation reserves," those words which a witness has turned into plain English in the way in which I have already said. The Auditor says that that satisfied his doubts; he thought then that he had done enough to cure the defective character of the Balance Sheet or Profit and Loss Account with those words. If he was right in that, if he had discharged his duty sufficiently and properly, then it seems, on any view, that the matter is, or ought to be, at an end. If, on the other hand, he was wrong in this sense that in a civil action, or in an action against him for not showing due care and skill, he would be held liable as a defendant because he had broken his duty and not fully discharged his office, then, again, his liability would be a civil liability in damages.

Smith v. *Sheard* (1906), Acct. L.R. 65

This case was brought against Mr. Sheard for damages for neglect in the audit of the plaintiff's books. The defendant denied that he was employed to audit the books. He was only employed as an accountant to prepare accounts. The whole question turned on what were the terms of the defendant's employment. By inadvertence the defendant in sending in his bill of charges had used the word "audit," but he explained that the word was only used in a loose way. The jury found there had been a contract to audit. Consequently the defendant was liable for damages.

Although the verdict was in favour of the plaintiff, the summing up by the Judge and his review of the evidence appears to be in favour of the defendant.

It would be no part of their office to inquire into the validity of any transactions appearing in the accounts of the company . . . the duty prescribed for the Auditors is to inspect, examine, and check the receipts, payments, vouchers, and accounts of the company."—*Spackman* v. *Evans* (1868), L.R. 3 H.L. 236.

Henry Squire (*Cash Chemist*), *Ltd.* v. *Ball, Baker & Co.* 1911, 44 Acct. L.R. 25, *and Mead* v. *Ball, Baker & Co.* (1911) 45, Acct. L.R.

In these actions it was sought to recover damages from the Auditors for negligence in carrying out their duties, especially in respect of irregular increases in stock, which it was alleged the Auditors should have detected. There had been falsification of documents and omissions of liabilities.

It was proved that the Auditors had called the attention of the Directors to what appeared to be an excessive increase in the stocks and that they relied for the valuation of the stock on the statements of the manager and secretary.

In the course of his judgment Lord Alverstone, C.J., made the following observations—

I do not agree that their duty as Auditors would be less than their duty as advising a purchaser who was buying a business.

I do not attach any importance to the low scale of remuneration.

It has been held over and over again, and it has been recognized in the Court of Appeal, that it is not his duty to take the stock.

Can it be truly said that the Auditors were wanting in reasonable care in thinking it not necessary to test the managing director's returns? I cannot bring myself to think they were, nor do I think any jury of business men would take a different view.

Therefore we have a case before us where, if it is negligence at all, it is negligence with regard to Stock Sheets and nothing else.

I further rule, as a guidance to myself, that, with some slight exceptions where judgment and discretion come in, the skill of the clerk must be the same as the skill of the principal. The principal must not excuse himself for his clerk's negligence by saying that he employed a clerk.

Why should it be supposed that it is to arouse the suspicion of the Auditors when the fact of the increase of stock and the existence of increased stock is called to the attention of the Directors by the Auditors and no comment of any sort or kind is made?

All I say is I have yet to learn that if the Auditors call the attention of the Directors of the company to the fact, they may not also rely upon the fact that the Directors of the company, with that information before them, make no further comment and give no further instructions.

I must say I certainly should have thought that the fact that the attention was being called of Mr. Mead, who was a director, and of Mr. Reece, who was also a director, to this fact, and that neither Mr. Mead nor Mr. Reece—certainly not Mr. Mead—thought it their duty, or fair to the Auditors, to give them any extra caution, is a circumstance not to be lost sight of when we are dealing with alleged negligence in three consecutive years.

It is extremely easy when you are wise after the event to pick out particular things and say that they would have indicated to you that there was something wrong about the Stock Sheets—that is the strongest that it has been put to me—calling for further inquiries. All I can say is that it does not to my mind appear to be a reasonable view.

One cannot help saying that this is evidence given after a fraud has been discovered.

His Lordship also pointed out that the principal witnesses called by the plaintiffs had given evidence as follows—

We agree, *prima facie*, given certified Stock Sheets, all the Auditors need do in the first instance, apart from suspicion being aroused, is to take totals and extensions. That would be an ample discharge of their duty when there is a duly certified Stock Sheet, correcting extensions and totals, and checking a sufficient number of Stock Sheets which are found to be accurate.

Both actions were dismissed with costs.

Re Western Counties Steam Bakeries and Milling Co., Ltd., [1897] 1 Ch. 617

In this case the accountants were employed by one of the Directors to audit the accounts of the company for a certain year. The Balance Sheet was issued containing their Report and, on the strength of the Balance Sheet, dividends were paid. The liquidator of the company brought the action under Section 10 of the Companies Winding Up Act, 1890 (now Section 276 of the Companies Act, 1929), to recover the amounts from the Auditors on the grounds of misfeasance. The decision of the Court was that to be liable as officers of the company, the Auditors must be properly appointed and could not, therefore, in this case be charged with misfeasance. The question to be settled is whether the Auditors are officers of the company. To be an officer there must be an office and an office imports a position with the duty which attaches to it. By acting as an Auditor a person may become a *de facto* auditor, but the Section does not subject the Auditor to proceedings. It is only when he is *de facto* or *de jure* an officer of the company that he can be proceeded against by summons. The question is not whether the accountants were *de facto* auditors, it is were they *de facto* officers.

Re The Westminster Road Construction & Engineering Co., Ltd., (1932), Acct. L.R. 38

This was a misfeasance summons issued by the Liquidator in respect of alleged wrongful payment of dividends. The action turned on the question of work-in-progress and omission of liabilities. The Auditor was found guilty of negligence.

Mr. Justice Bennett said—

It was settled law that an Auditor did not discharge his duty if he merely saw that the Balance Sheet accurately represented what was shown by the books on the material date. His duty with regard to the ascertainment of unrecorded liabilities must depend upon the facts of each particular case and must be determined by the nature of the business carried on and the practice of the persons or bodies with whom the company did business of sending in their invoices. If the Auditor found that a company in the course of its business was incurring liabilities of a particular kind, and that the creditors sent in their invoices after an interval, and that liabilities of the kind in question must have been incurred during the accountancy period under audit, and that when he was making his audit a sufficient time had not elapsed for the invoices relating to such liabilities to have

been received and recorded in the company's books, it became his duty to make specific inquiries as to the existence of such liabilities and also, before he signed a certificate as to the accuracy of the Balance Sheet, to go through the invoice files of the company in order to see that no invoices relating to liabilities had been omitted.

With regard to the over-valuation of work-in-progress the expert evidence was that it was the duty of the Auditor to check the figures at which work-in-progress was brought into the Balance Sheet. It was the duty of the Auditor to satisfy himself that nothing was included in the work valued as in progress on 31st March, which was in fact done after that date. He had also to satisfy himself that all expenses or liabilities incurred by the company in connexion with the work so valued had been brought into account.

Wilde and Others v. *Cape and Dalgleish* (1897), 23 Acct. L.R. 81

This is a case in which there was misunderstanding as to the terms of employment. The defendant stated that he had *audited* the plaintiff's books in order to ascertain the Profit and Loss Account as between the partners, accepting the accuracy of the entries appearing in the books. He repudiated all responsibility for not having discovered the defalcations of the plaintiffs' cashier.

The action arose because the defendant had not examined the plaintiffs' pass book, and so had not discovered certain fraudulent entries made therein.

It was represented by the plaintiffs that a previous member of the defendant firm, since deceased, had settled the terms of employment.

In view of the plaintiffs' evidence, the defendant agreed to pay one-half of the loss and the case was settled on that footing.

Having regard to his contention, the defendant seems to have used the word "audited" loosely.

Wood v. *Woodhouse & Rawson United*, [1896] W.N. 4

In an action to realize debentures granted by a company, which was afterwards ordered to be wound up, a summons was taken out by the Official Receiver and Liquidator, asking for the leave of the Court to take misfeasance proceedings against the Directors and Auditors of the company, and that the costs might be provided by the Receiver in the action. A majority of the debenture-holders was opposed to misfeasance proceedings being taken at the expense of the assets covered by the debentures, and also to abandoning the claims of the debenture-holders to any sums recovered in the proceedings. A suggestion was, however, made by a debenture-holder that if there were people who believed they could make a good thing out of a misfeasance summons they would be prepared, for the right to step into the debenture-holders' shoes, to pay a substantial sum, but that the right should not be given up without anything in return. It was held that an

order must be made directing the Receiver to sell by auction the claim against the Directors and Auditors.

The conclusions to be drawn from the foregoing cases are that if an Auditor acts with intelligence, skill, and care, and has no reasonable ground for suspicion, he is not guilty of negligence but that, as usual, each case depends on the actual circumstances. In the case of a limited company the Auditor is expected to be aware of the contents of the Memorandum and Articles of Association.

It is also obvious that the terms of the contract between the accountant and his client should be explicit.

Many of the cases are of a somewhat remote date, and in view of the progress made by the accountancy profession, a higher standard of professional skill and experience may be exacted in the future.

Section 372 of the Companies Act, 1929, gives the Court power to grant relief in certain cases. The Section is as follows—

372. (1) If in any proceeding for negligence, default, breach of duty, or breach of trust against a person to whom this Section applies it appears to the Court hearing the case that that person is or may be liable in respect of the negligence, default, breach of duty or breach of trust, but that he has acted honestly and reasonably, and that, having regard to all the circumstances of the case, including those connected with his appointment, he ought fairly to be excused for the negligence, default, breach of duty or breach of trust, that Court may relieve him, either wholly or partly, from his liability on such terms as the Court may think fit.

(2) Where any person to whom this Section applies has reason to apprehend that any claim will or might be made against him in respect of any negligence, default, breach of duty or breach of trust, he may apply to the Court for relief, and the Court on any such appplication shall have the same power to relieve him as under this Section it would have had if it had been a Court before which proceedings against that person for negligence, default, breach of duty or breach of trust had been brought.

(3) Where any case to which subsection (1) of this Section applies is being tried by a judge with a jury, the judge, after hearing the evidence, may, if he is satisfied that the defendant ought in pursuance of that subsection to be relieved either in whole or in part from the liability sought to be enforced against him, withdraw the case in whole or in part from the jury and forthwith direct judgment to be entered for the defendant on such terms as to costs or otherwise as the judge may think proper.

(4) The persons to whom this Section applies are the following—

(*a*) Directors of a company:
(*b*) Managers of a company:
(*c*) Officers of a company:
(*d*) Persons employed by a company as Auditors, whether they are or are not officers of the company.

In an address to the London Members of the Institute of Chartered Accountants on 18th January, 1934 (reported in *The Accountant* of 27th January, 1934), Sir Nicholas Waterhouse made a striking contribution on the subject of "Liability of Auditors."

The address is so much to the point that the authors have obtained the kind consent of Sir Nicholas Waterhouse to reproduce it in full.

All of you are no doubt familiar with those fascinating mystery stories at the end of which the brilliant amateur detective confounds the painstaking inspector by pointing to the perpetrator of the crime and at the same time to some small step which the inspector might have taken and thereby have placed himself on the sure road to discovery. When this denouement occurs it counts for nothing that the inspector has taken all those steps which experience has shown to be most likely to result in detection of such a crime as has been committed, nor is it deemed relevant that to have taken all the unlikely steps, one of which, as it turns out, would have resulted in discovery, would have necessitated the employment of men and time to an extent far beyond his resources. He is left to bear with what equanimity he can command the tolerant superiority of the amateur and the more open scorn of the minor characters in the story.

The feelings aroused in readers of such tales vary—some are lost in admiration of the achievements of the brilliant amateur, others feel a certain sympathy with the criminal whose well-laid plans have been frustrated by the combination of a seemingly inconsequential error and the uncanny intuition of his Nemesis; few waste any sympathy upon the discomfited inspector. But among those few (if it be true that a fellow feeling makes us wondrous kind) should be found those readers who happen to be professional auditors of accounts. For if they have been so fortunate as to enjoy a considerable practice, they are almost certain to be reminded of occasions on which they have vainly attempted to explain the fact that a defalcation undiscovered by them has been perpetrated in connexion with accounts which have been subjected to their audit. At such a time the sufferer from the defalcation is apt to be unable to see anything except the one fact that an apparently simple step involving perhaps no greater amount of work would have led to the detection of the fraud. Patiently, but with small hope of success, the auditor explains that the steps which he did take would in ninety-nine out of a hundred cases be more likely to prove effective, and that if he had done all the many things that might possibly have unearthed the defalcation, the scope and extent of the audit would have been extended beyond all reason; delicately he points out things which the client himself or his staff might have done which would have made such a defalcation impossible or resulted in its discovery.

The analogy is not perfect. In the mystery story it is not suggested that the unsuccessful inspector should be cast in pecuniary damages for his failure or even that he should lose his position. The auditor is lucky if he is not confronted with both these suggestions.

In justice to one's clients let me say that many of them, when satisfied that the auditor has served them loyally and carried out his duties conscientiously, are willing to take a reasonable view of such a case. There are, however, exceptions, particularly in those cases where to absolve the auditor from blame is to imply that the directors themselves were negligent, or where the fraudulent employee has been the subject of a fidelity bond and the insurer refuses to accept liability until it has been proved that the auditor has not been negligent. The professional auditor is then at a distinct disadvantage and the case is made more delicate and difficult for him by the fact that his principal asset is his reputation and that resistance to the claim may result in damage to that reputation whether or not it results in a pecuniary liability.

Now, the lawyers may tell us that this is wholly a matter of contract,

express or implied, and that it is for the accountant to see that the respective rights and obligations of his clients, the insurers and himself, are defined to his satisfaction. I think that in cases in which the auditor is retained expressly to make an internal audit it is possible at the time of making the contract to define his position in the unfortunate event of a defalcation taking place and escaping detection by him. And, in passing, may I say that he should not accept a contractual relationship under which he may be held pecuniarily liable if he fails to live up to the standards of effectiveness set by the heroes of detective fiction.

For the present, however, I should like to direct your attention to the narrower question which is presented when the auditor is appointed under the Companies Acts and assumes purely statutory obligations. Since the question has not been settled by legal decisions, and since I am not a lawyer, I am not going to undertake to define the legal position. I am going to put before you only the view suggested by my knowledge, inherited or acquired, of the history of the law, and by my experience in the field of business as well as in that of auditing.

The protection of a company against risks of fraud by its employees, the detection of frauds which occur and the recovery of whatever reparation can be obtained, are obviously purely administrative functions. The problem of safeguarding transactions is always a matter of weighing the risks of loss against the costs of protection, and, therefore, a matter lying wholly in the field of business judgment. The detection of frauds is usually most likely to be accomplished by continuous supervision which, unless the volume of business is small, can best be given by persons regularly employed for that purpose. Indeed, modern developments, and particularly the increased use of mechanical devices, while resulting in greater economy, accuracy and expedition in the field of book-keeping, have undoubtedly made the detailed audit which is not continuous and practically contemporaneous with the transactions audited extremely difficult and expensive.

It cannot, therefore, be questioned that, apart from the statute, the work of detecting fraud falls on the directors and on those whom they employ. Nor is there, I think, the slightest ground for a suggestion that the audit provisions of the Companies Acts have in any degree changed this position.

The provisions of the Companies Acts relating to the duties of auditors are, of course, familiar to you, but it may be desirable here to recall the precise language in which they are expressed in Section 134 (1) of the Act of 1929, as follows—

> "The auditors shall make a report to the members on the accounts examined by them, and on every balance sheet laid before the company in general meeting during their tenure of office, and the report shall state—
>
> "(*a*) Whether or not they have obtained all the information and explanations they have required, and
>
> "(*b*) Whether in their opinion the balance sheet referred to in the report is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs according to the best of their information and the explanations given to them and as shown by the books of the company."

The sole objective of the auditor's work which is indicated is the formulation by the auditor of an informed opinion on the question whether the balance sheet of the company exhibits a true and correct view of the state of the company's affairs. This is a far less onerous task than for the auditors to satisfy themselves as far as possible (the limitation is inescapable)

whether all the transactions of the company have been faithfully recorded and all funds honestly administered.

Attempts are sometimes made to impose the more onerous responsibility on the auditor by inference. The auditor must see that the balance sheet is exactly correct (so runs the argument) and it cannot be correct unless all the transactions are correctly reflected therein; therefore the auditor must do everything in his power to satisfy himself that all the transactions are honestly and properly recorded. This argument not only overstates in its premise the express requirements of the Act, but in its conclusion violates the principles which govern the construction of statutes.

If Parliament had intended to impose the more onerous duty on auditors, it would have done so in express terms; it would not have defined the minor obligation and left the major obligation a matter of inference. The contrast in this respect between the general Companies Acts and Acts such as the Building Societies Act of 1874 or the Friendly Societies Act, 1896, is striking and significant. Section 27 of the latter Act reads in part as follows—

> Section 27: "Every registered society and branch shall once in every year . . . send to the Registrar a return . . . of the receipts and expenditure, funds and effects of the society or branch as audited."
>
> Section 26: "The auditors shall have access to all the books and accounts of the society or branch, and shall examine the annual return mentioned in this Act, and verify the annual return with the accounts and vouchers relating thereto, and shall either sign the annual return as found by them to be correct, duly vouched and in accordance with law, or specially report to the society or branch in what respects they find it incorrect, unvouched, or not in accordance with law."

It would have been easy to embody similar language in the general company law, but this has never been done, no doubt for the simple reason that it was not necessary to the accomplishment of the purpose which Parliament had in contemplation, viz. a reasonable measure of protection for members against deception or other wrongful acts on the part of directors and officers. It was no part of this purpose to assign to the members and the auditor appointed by them duties which properly belong to the directors.

The origin and development of the audit imposed by Section 134 (1) of the Act of 1929, which perhaps for the sake of brevity I may allude to hereafter as the "official" audit, is fairly summarized in Spicer & Pegler's *Practical Auditing*, 3rd edition, page 13, as follows—

> "The fact that the whole control of the company was vested in the directors, rendered it necessary that some means should be utilized of enabling the shareholders to be assured that the accounts presented to them by the Board correctly represented the state of affairs of the company and that the directors had not utilized their position for the purpose of misappropriating the funds of the company or using them for their private gain. It was impracticable, however, for every individual shareholder to satisfy himself on these points, for as a rule he was not possessed of the requisite technical knowledge and the right of inspection and inquiry could not be given to one shareholder without it being granted to all. Consequently, it became usual for shareholders to appoint one or more of their number to act as Auditor or Auditors of the company and to report to the shareholders on their examination of the Balance Sheet and Accounts. Subsequently it was found inadvisable to confine this function to individual shareholders who might not be possessed of the requisite qualifications, and it became usual to appoint Professional Auditors to act on behalf of the shareholders generally."

In discussions of this subject a statement by the late Professor Dicksee is sometimes quoted to the effect that the object or scope of an audit may be defined as threefold—

1. Detection of fraud.
2. Detection of technical errors.
3. Detection of errors of principle.

This language, however, occurs in the course of a discussion on auditing in its broadest sense, and when an accountant is specifically employed to make a complete internal audit it is, I think, applicable. It is, however, I suggest, wholly inappropriate in relation to audits under the Companies Acts. Indeed, Professor Dicksee goes on to say quite correctly: "The extent of an auditor's duties depends entirely upon the express or implied contract between himself and his client."

I suggest that the scope of the official audit is rather—

(1) To ascertain whether any balance sheets or other accounts submitted to members are in accord with the books of accounts from which they would ordinarily be made up;

(2) To reach by examination and inquiry a reasonably informed opinion on the question whether the books are so kept that a true and correct view of the state of the company's affairs can be obtained therefrom;

(3) To determine whether the directors and officers of the company in preparing from the books the balance sheets or other accounts and submitting them to members have dealt fairly and honestly with the members.

The duties imposed on the auditors by Section 134 (1) in respect of accounts other than balance sheets are quite indefinite. The auditors are not expressly required to examine any other accounts—if they do so they must report on them; but the nature of the report to be made is not indicated as it is in the case of the balance sheet. Where, however, accounts are so closely related to the balance sheet as to constitute a part of the information given to members in relation to the state of the company's affairs, the auditor will be wise to regard them for this purpose as a part of the balance sheet.

The auditor must not form his opinion lightly, but he is not required to know everything that there is to be known about a company before he does so.

The duty imposed on the auditor has remained substantially unchanged from the enactment of the Companies Act of 1862 (Table A) to the present time; there is nothing to indicate that in the intervening seventy years the conception of the role of the members' auditor has been materially changed. It may be noted, however, that changes such as the substitution of the word "report" for the word "certify" do not suggest any enlargement of the auditor's obligation.

No one would propose that in the case of large undertakings the auditors, as an incident to the determination of the state of the company's affairs, should undertake to duplicate the work done by the internal auditing department of the company. The law makes no distinction between large and small companies, and the only interpretation of the Act capable of general application is that it leaves the responsibility for the internal audit to the directors and their appointees.

It is quite true that in the case of small companies the maintenance of an elaborate organisation such as would afford adequate internal checks might involve undue expense, and it is doubtless generally true that in such cases economy and efficiency can best be combined by arranging for continuous or frequent checks of the accounts by professional accountants.

Moreover, the most convenient and economical course for the directors to adopt will usually be to retain for such a purpose the professional accountants who act as statutory auditors of the company. But I submit that there is a clear distinction between the work done by the accountants upon the instructions of the directors, practically as a part of the internal machinery of the company, and the work which falls to them as statutory auditors. If in such a case a defalcation occurs and escapes detection, questions may arise concerning the liability of the auditors. The first will be whether there is any liability in respect of their position as statutory auditors, or whether the liability, if any, arises from their employment by the directors.

In my view, the question of defalcations arises in connexion with the official audit only incidentally in cases where one effect of the defalcation is that the balance sheet (or an account so related thereto as to come within the scope of the auditors' report) is incorrect to a material extent, as, for instance, where debts carried as assets have in fact been collected and the proceeds appropriated by the defaulter.

In considering the position of a statutory auditor in relation to a defalcation the vital question would seem to be whether a reasonable inquiry into the state of the company's affairs would have disclosed the over-statement and consequently the defalcation. If so, the auditor will no doubt be liable for the consequence of his failure to detect the over-statement of assets, but the question will still remain how far the fact that if he had done so further defalcations might have been prevented can properly be taken into account in assessing damages against him.

It is difficult to see how any claim could be asserted where the defalcations have been covered up in charges to expenses accounts so that the assets are not overstated and where the profit and loss account shows a single figure of profit "after deduction of all losses and expenses."

The extent of the auditors' liability arising out of employment by the directors will turn on the nature of their contract.

A number of cases in which claims against auditors for non-discovery of defalcations were based on their contract of employment have been before the Courts, but I know of no case in which such a liability has been asserted against an auditor in respect of his purely statutory duties under the Companies Act.

We are all familiar with the language in the decisions in the *London and General Bank* case and the *Kingston Cotton Mills* case. In those cases the auditors had been misled into making reports in which, as subsequently appeared, the assets were grossly overstated—a matter upon which they were required by the express terms of the Act to report. When it is recalled that even upon this issue the Court used such language as—

> "He is justified in believing tried servants of the company in whom confidence is placed by the company."
>
> "He is entitled to assume that they are honest and to rely upon their representations provided he takes reasonable care."
>
> "Auditors must not be made liable for not tracking down ingenious and carefully laid schemes of fraud when there is nothing to arouse their suspicion and when these frauds are perpetrated by tried servants of the company and are undetected for years by the directors."
>
> "Where there is nothing to excite suspicion very little inquiry will be reasonable and sufficient, and in practice I believe business men select a few cases haphazard, see that they are right, and assume that others like them are correct also."

it would seem safe to assume that the Court would not hold an auditor

to a higher standard of responsibility in respect of duties which are not mentioned in the Act, and the assertion of which is an attempt greatly to extend by inference the express requirements of the Act, and to transfer to the appointees of the members duties and obligations which naturally and logically attach to the directors and those appointed by them.

I should not like it to be thought for a moment that in my view a statutory auditor need feel no concern as to the degree of efficiency of the protection afforded by the company's methods against defalcations by employees, or that he should take no steps to satisfy himself that the system is being carried out in practice. On the contrary an auditor, even if undertaking nothing more than the official audit, should always examine the methods of control and test their working before he accepts the books as a basis for a balance sheet which he proposes in his report to approve as exhibiting a true and correct view of the state of the company's affairs. An auditor, who had signed a balance sheet which had been proved to be substantially incorrect and sought to defend himself on the ground that the balance sheet was in accordance with the information and explanations secured by him and was as shown by the books of the company, would find his defence gravely compromised if it were demonstrated that the accounting methods and control of the company were so lax and inadequate that no reliance could properly be placed upon the books.

Not only so, but while the auditor may properly refuse to accept a pecuniary responsibility which does not justly attach to his work, he has (if, as is now customary, he is a professional accountant) an obligation to make his work as valuable to his clients as possible within the limits of his appointment. His expert survey of the methods employed and the moral effect of intelligent tests of the working of the system, restricted though those tests may be, will exercise a valuable deterrent influence. I believe that the purpose of the modern criminal law is to act as a deterrent, the punishment of the individual being regarded as necessary to this purpose rather than retributive. No one denies, just because crimes are still committed, that the law and the police have such an effect nor can the deterrent effect of audits be denied because defalcations still occur.

The correct view of the relation of the shareholders' audit to the question of defalcations by employees is, I suggest, that it has this, by no means inconsiderable, preventive value, but involves no sort of guarantee nor any undertaking to be responsible for the consequences if in a particular case such an audit neither prevents nor discloses a defalcation. It should not be relied on to disclose defalcations except in so far as discovery would be a natural result of any reasonably adequate inquiry into the state of the company's affairs. If the directors desire further protection in the form of supplementary service by the auditor, the extent of the protection and the corresponding liability become matters of contract.

In the United States I believe there is no official audit, but the question of the scope of an examination sufficient to warrant a report by auditors, somewhat similar to that called for by our statute, has received considerable attention in recent years. As early as 1917, the question what examination was sufficient to justify a balance sheet being certified for credit purposes was considered by the Federal Trade Commission (a body somewhat analogous to the Board of Trade) and by the Federal Reserve Board (which supervises the federal banking system), and a pamphlet was issued by the latter body in that year and was revised in 1929. During the current year the New York Stock Exchange had indicated that it regards the scheme of examination outlined in that pamphlet as justifying certification of the balance sheet for submission to shareholders. It is interesting to note that in the first paragraph of this pamphlet it is stated

that the procedure outlined "will not necessarily disclose defalcations," so that apparently the view in America is that an examination which is not sufficiently extensive to ensure the disclosure of defalcations may be entirely adequate as a basis for reporting to shareholders whether a given balance sheet exhibits a correct view of the financial position of the company. Anyone who has read the pamphlet will, I am sure, share that view.

What, then, should be the nature of the contract between the company and the auditor? Obviously, there must be a wide range in the scope of usefulness of the professional auditor in varying circumstances. The principal determining factors are, perhaps, the size and number of individual transactions and the extent of the internal audit. A company with a small staff entering into a relatively small number of important transactions may prudently instruct the auditor to make the most complete verification possible. Conversely, a company with a large staff, entering into a large number of relatively small transactions should rely mainly on a proper subdivision of work and internal audit, and ask the auditor to do no more than to satisfy himself thoroughly of the theoretical effectiveness of the internal system and make such tests of its practical working as will convince him that it is being made effective in practice. Between these limits varying degrees of completeness in the work of the auditor may be appropriate.

Naturally the fee and the degree of responsibility assumed must both vary as the audit is more or less extensive. And on this point I should like to say a word of caution to the practising accountant, and especially to those beginning practice.

We sometimes hear complaints that after a defalcation has been discovered clients take a view of the extent of the work which the auditor should have performed which is far more comprehensive than that which they took when instructing him and arranging the fee. The auditor should avoid the corresponding unfairness of leading his client to expect a greater degree of protection than the procedure he proposes to adopt will in reality afford. To-day the value of the work of auditors is too highly appreciated for it to be excusable for the auditor to emulate the share-pusher and attribute to his work a value greater than it can be expected to possess.

However extensive his work, an auditor should not be expected to agree to assume a pecuniary responsibility for losses which might have been avoided had he discovered a defalcation which for a time escapes detection, without regard to the amount of the loss, or to the ingenuity of the methods employed by the defaulter or to the fact that the directors or employees of the company may by their acts or negligence have contributed to the successful concealment of the irregularities.

This is essentially a risk to be covered by an insurance, the amount of which is predetermined and the cost or premium commensurate with that amount. The audit should greatly reduce the risk, and, therefore, the necessary premium, but it should not be regarded as in the nature of insurance or reinsurance.

It is an entirely mistaken notion which is, however, held by some people, that an auditor is legally liable for the amount of any defalcation which occurs after the date of an audit at which he might have discovered that one was being perpetrated, without regard to the difficulties of detection or to the extent to which the directors may have contributed to the loss by their acts or negligence. No cases involving this question have, I believe, reached the higher courts, but in the *London Oil Storage Co.* case (1904) it was considered very carefully. That case was tried by Lord Alverstone, and Mr. Rufus Isaacs (afterwards Lord Reading) was counsel for the auditor. The neglect complained of was failure at any time to verify a petty cash balance which over a period of years had increased from about

£100 to nearly £800. It was thus a step which might be regarded as incidental to a determination of the state of the company's affairs. The auditor was appointed under the articles of association, which were rather more stringent than the provisions of the present statute. In his charge to the jury, the Lord Chief Justice said—

> "The conduct of the directors is no answer to any breach of duty by the defendant, but it is a circumstance you must take into consideration, because if you are of opinion that the loss was occasioned by a man stealing the money in consequence of there being a want of proper control over him, then the fact of there being a breach of duty by the auditor is what we lawyers call a *causa causans* which contributed to, but would not be the cause of, the loss. I do not know that I ever remember a question the solution of which was more difficult in the concrete. It is easy to put it in general terms: Was he guilty of breach of duty, and if so, what loss was occasioned to this company by that breach of duty? You must not put upon him the loss by reason of theft occurring afterwards or before, but you must put upon him such damages as you consider in your opinion were really caused by his not having fulfilled his duty as auditor of the company."

The jury found that there was a breach of duty extending over four years, but they assessed the damages at only five guineas, adding that they considered the directors to have been guilty of gross negligence. In the course of the subsequent discussion of the judgment to be entered, the Lord Chief Justice said—

> "It was not a case in which Mr. Hasluck had said (as he might have said quite honourably, I think): 'My clerk was careless but the directors so acted that it caused the company no damage.' If that had been the way the case had been fought, I think Mr. Isaacs's contention would have been unanswerable, and that the action ought not to have been brought."

In one of the decisions of our Court of Appeal which I have already quoted the following sentence occurs—

> "If there is anything calculated to arouse suspicion he should probe it to the bottom, but in the absence of anything of that kind he is only bound to be reasonably cautious and careful."

I have been surprised to find this language interpreted as meaning that when once an auditor's suspicions are aroused he must as a part of his statutory duty and without special compensation continue his investigations until he has found the truth, however deeply it may be buried.

I do not think that many clients would take such a view; most of them would, I feel sure, be appreciative of the vigilance of the auditor which had resulted in discovering the defalcation and be content themselves to bear the expense of investigating its extent and its effect on the state of the company's affairs. In any case it is satisfactory to find that Lord Alverstone lent no support to the exaggerated view of the auditor's duty for, after quoting the language above cited, he said—

> "And apart from the circumstances of this case, I think Mr. Hasluck made an answer which shows that he appreciated his duty when he said, 'Had I any reason to think that the amount of cash retained at the city office was too much, I should have gone to the directors and asked for an explanation: that would have been my duty.' and so far as I may express an opinion, I think that is a true view of what his duty would have been under the statute and the articles. He ought, if his suspicion was aroused by anything that was called to his attention, to have gone to the directors and asked for an explanation."

Some years ago an interesting American case was reported in *The Accountant*. The auditors of a New York stockbroker's firm receiving an annual fee of not more than $2,000 were sued for damages and at the end of the trial the judge finally left to the jury two questions—

(1) Were the defendants negligent in the performance of their agreement, and (2) if so, what damages to the plaintiffs resulted directly and proximately from such negligence? The first question was answered in the affirmative, and to the second the jury answered "$1,177,805·26."

Afterwards, however, the Court set aside the answer to the second question and directed a verdict in favour of the plaintiffs in the amount of $2,000. Upon appeal the Appellate Division of the State of New York, by a majority of three to one, sustained the decision of the lower court, and in doing so, said with regard to the damages of $1,177,805—

> "We think the damages cannot be said to flow naturally or directly from defendants' negligence or breach of contract. Plaintiffs should not be allowed to recover for losses which they could have avoided by the exercise of reasonable care."

The Court of Appeals of New York, a court which I believe possesses an authority in America only less than the Supreme Court of the United States, unanimously confirmed the decision of the Appellate Court.

Quite recently, the Court of Appeals of Manitoba gave a decision in an extremely interesting case (*International Laboratories Ltd.* v. *Dewar et al*, [1932] 3 W.W.R. 174; revsd. [1933] 2 W.W.R. 529). In the Court of First Instance the judge made a number of decisions adverse to the auditors which, if they had been sustained, would, I think, have made a complete reconsideration of the legal position of auditors inevitable.

The company was a subsidiary with no stockholders except the holding company, and the audit arrangements had been made by correspondence with the officers of the holding company and confirmed by those of the subsidiary. The auditors had undertaken a restricted audit, after warning their clients of the risks such restriction entailed. The loss was covered by insurance, and it was admitted that the suit was brought in the interest of insurers. The defalcations were ultimately discovered by the auditors, who were instructed by the company to investigate the records and determine the amount stolen.

The trial judge, that is the judge of the Court of First Instance, dismissed the correspondence from consideration, holding that it was ineffectual to relieve the auditors of a duty which was imposed on them by the statute, the proper performance of which would, in his view, have resulted in the prompt discovery of the defalcations in the first year in which they occurred; that the auditors were consequently liable for the amount of all subsequent defalcations, and that the insurers were entitled to recover upon the principle of subrogation. How extreme were his views on the responsibility of auditors may be judged from a single sentence quoted from his decision—

> "When the defendants assumed their duties and continued to carry them out from year to year, the necessity for special vigilance by the plaintiff as against its employees was removed."

Fortunately for the profession, and as I think, for the business world also, the Appeal Court disagreed with the trial judge on his law as well as on his interpretation of the evidence. With one dissentient out of five judges, that Court completely reversed the decision of the court below and decided the issues in favour of the auditors, both on the claim and the counter-claim for services investigating the thefts. The dissenting judge

would have found for the plaintiff on certain items constituting about one-third of the total claim.

All of the judges found their decisions on the contract created by the correspondence. With the exception noted, all agreed that there was no breach of duty under that contract. Since this conclusion disposed of the case, all further observations are in the nature of *obiter dicta*. Nevertheless, it seems worth while to quote the two following excerpts—

> "The liability sought to be imposed on the defendants is, in this view, based on the failure of the defendants to protect the plaintiff from its own negligence." (Trueman, J.A.)
>
> "There is a certain minimum of control which every firm is bound to exercise over the operations in its office and which the auditors will properly assume to have been exercised." (Prendergast, C.J.)

I do not think that the burden placed on the auditor is unreasonable, in theory, even under a contract express or implied that requires from him far more than the official audit. He is required to display only reasonable skill and reasonable diligence: he is not liable merely because he fails to discover a most ingenious fraud, and if the primary cause of the loss is negligent administration, his liability will, in law, be relatively small. What, then, are the reasons that make the question of liability a serious one.

The first is that, as stated by Lord Alverstone in the passage which I have already quoted, it is easier to define the auditor's liability in general terms than to deal with the question concretely. Consequently, the auditor is in the hands of a jury, and unless their decision is quite unreasonable it will not be interfered with. The second is that the question whether a fraud might have been discovered by reasonable skill and diligence is apt to take on a very different colour when the fraud has, in fact, been discovered and the means by which it might have been unearthed earlier have become apparent. It is too much to expect of jurymen that they should be able to put themselves back into the position of the auditor before the discovery had been made. In the third place, the question what constitutes reasonable skill and diligence is always a difficult one. The courts have indicated that such a question can best be answered by ascertaining whether other skilled persons would have regarded the procedure actually followed as adequate or whether they would have done something more which would have prevented or reduced the loss. It is easy to be wise after the event, and an expert may be prone to think that he would have done what as it turns out would have been effective; or, on the other hand, he may find it embarrassing to say that he would have done something which another expert, whom he regards as equally competent, did not do. Answers to hypothetical questions after the event are not a very satisfactory basis on which to have to depend for a decision whether a loss which may be disastrous is to fall upon an auditor.

Undoubtedly, however, the consideration which adds most to the seriousness of the question of the liability of an auditor is that he has so much more to lose than the person asserting the claim against him, and that claimants cannot fail to be aware of this fact. The mere fact that a suit for negligence is brought against him is apt to prove injurious whatever the outcome may be; and if he loses, the damages and costs may be out of all proportion to any compensation he has ever received. There is no doubt that recognition of these facts has led to claims being made and paid that could scarcely have survived scrutiny in a court of law.

It follows, I think, from the foregoing that the remedy for unsatisfactory conditions lies not in changes of the law but mainly in ourselves. If we are

careful what contracts, express or implied, we enter into; if we do our work with reasonable competence and diligence; if we make up our minds to face the trouble and annoyance which resistance to unfounded claims will sometimes entail, we have little to fear.

I think, however, that the organized bodies of the profession should do something to place the relations between clients, insurers and auditors on a more satisfactory footing. In the *Manitoba* case which I have mentioned Mr. Justice Robson said—

> "Much has been said about subrogation and suggestion that the insurers now have a right through plaintiff against defendants. I fail to see anything of the sort in the relationship of the parties."

If this is not the legal position in England steps should be taken to make it so, and I should suppose that this could readily be accomplished by appropriate wording in contracts of insurance.

CHAPTER XII

THE APPOINTMENT, REMUNERATION, RIGHTS AND DUTIES, AND RESPONSIBILITIES OF AUDITORS, AND LEGAL PRONOUNCEMENTS RELATING THERETO

APPOINTMENT

I. In the case of companies incorporated under the Companies Act, 1929, the appointment and remuneration are regulated by the following Sections of the Act—

132. (1) Every company shall at each annual general meeting appoint an Auditor or Auditors to hold office until the next annual general meeting.

(2) If an appointment of Auditors is not made at an annual general meeting, the Board of Trade may, on the application of any member of the company, appoint an Auditor of the company for the current year.

(3) A person, other than a retiring Auditor, shall not be capable of being appointed Auditor at an annual general meeting unless notice of an intention to nominate that person to the office of Auditor has been given by a member to the company not less than fourteen days before the annual general meeting, and the company shall send a copy of any such notice to the retiring Auditor, and shall give notice thereof to the members, either by advertisement or in any other mode allowed by the articles, not less than seven days before the annual general meeting:

Provided that if, after notice of the intention to nominate an Auditor has been so given, an annual general meeting is called for a date fourteen days or less after the notice has been given, the notice, though not given within the time required by this subsection, shall be deemed to have been properly given for the purposes thereof, and the notice to be sent or given by the company may, instead of being sent or given within the time required by this subsection, be sent or given at the same time as the notice of the annual general meeting.

(4) Subject as hereinafter provided, the first Auditors of the company may be appointed by the Directors at any time before the first annual general meeting, and Auditors so appointed shall hold office until that meeting:

Provided that—

(*a*) the company may at a general meeting of which notice has been served on the Auditors in the same manner as on members of the company remove any such Auditors and appoint in their place any other persons being persons who have been nominated for appointment by any member of the company and of whose nomination notice has been given to the members of the company not less than seven days before the date of the meeting; and

(*b*) if the Directors fail to exercise their powers under this subsection the company in general meeting may appoint the first Auditors, and thereupon the said powers of the Directors shall cease.

(5) The Directors may fill any casual vacancy in the office of Auditor, but while any such vacancy continues the surviving or continuing Auditor or Auditors, if any, may act.

(6) The remuneration of the Auditors of a company shall be fixed by the company in general meeting, except that the remuneration of an Auditor

appointed before the first annual general meeting, or of an Auditor appointed to fill a casual vacancy, may be fixed by the Directors, and that the remuneration of an Auditor appointed by the Board of Trade may be fixed by the Board.

133. (1) None of the following persons shall be qualified for appointment as Auditor of a company—

(a) a Director or officer of the company;

(b) except where the company is a private company, a person who is a partner of or in the employment of an officer of the company;

(c) a body corporate.

(2) Nothing in this Section shall disqualify a body corporate from acting as Auditor of a company if acting under an appointment made before the third day of August, nineteen hundred and twenty-eight, but subject as aforesaid any body corporate which acts as Auditor of a company shall be liable to a fine not exceeding one hundred pounds.

(3) In the application of this Section to Scotland the expression "body corporate" does not include a firm.

The legal duties and rights of Auditors are set out in Section 134 (see page 163).

II. In the case of Parliamentary Companies (Companies incorporated under a special Act of Parliament) the appointment is made in the first instance by the Directors and the remuneration fixed by them.

III. In the case of Public Audits comprising Societies registered under the Industrial and Provident Societies Acts, 1893 to 1929, Friendly Societies Acts, 1896 to 1929, and Industrial Assurance Acts, 1923 to 1929, the following provisions apply—

Sections 13, 14 and 72 of the Industrial and Provident Societies Act, 1893, are as follows—

13. (2) The Auditors shall have access to all the books, deeds, documents and accounts of the society, and shall examine the Balance Sheets showing the receipts and expenditure, funds and effects of the society, and verify the same with the books, deeds, documents, accounts, and vouchers relating thereto, and shall either sign the same as found by them, to be correct, duly vouched and in accordance with law, or specially report to the society in what respects they find them incorrect, unvouched, or not in accordance with law.

14. (1) Every registered society shall once in every year, not later than the thirty-first day of March, send to the registrar an annual return of the receipts and expenditure, funds and effects, of the society as audited.

(2) The annual return—

(a) Shall be signed by the Auditor or Auditors; and

(b) Shall show separately the expenditure in respect of the several objects of the society; and

(c) Shall be made up from the date of its registration or last annual return to that of its last published Balance Sheet, unless the last-mentioned date is more than four months before or more than one month after the thirty-first day of December, in which case it shall be made up to the said thirty-first day of December inclusive; and (*amended by Act of* 1913)

(d) Shall state whether the audit has been conducted by a Public Auditor appointed as by this Act is provided and by whom.

A registered society shall, together with the annual return, send to the Registrar a copy of the report of the Auditors and a copy of each Balance Sheet made during the period included in the return. (*Added by Act of* 1913.)

72. The Treasury may appoint Public Auditors for the purposes of this Act, and may determine the rates of remuneration to be paid by registered societies for the services of such Auditors.

Section 2 of the Industrial and Provident Societies (Amendment) Act, 1913, is as follows—

Every registered society shall once in every year submit its accounts for audit to one or more of the Public Auditors appointed under the provisions of the principal Act. An Auditor shall not hold any other office in connexion with the Society. (*This is substituted for sec.* 13 (1) *of the* 1893 *Act.*)

The following is an official statement of the conditions including remuneration under which Public Auditors hold their appointments—

INDUSTRIAL AND PROVIDENT SOCIETIES ACTS, 1893 TO 1928

FRIENDLY SOCIETIES ACTS, 1896 TO 1929

AND

INDUSTRIAL ASSURANCE ACTS, 1923 TO 1929

Conditions under which Public Auditors hold their Appointments

1. Public Auditors hold their appointments from year to year as from the 1st January. Any change of address should be communicated immediately to the Registrar of Friendly Societies.

2. A Public Auditor may describe himself as a "Public Auditor under the Friendly Societies Acts and the Industrial and Provident Societies Acts," but must not by reason of his appointment use any other description.

3. Public Auditors are expected to make themselves acquainted with the provisions of the Industrial and Provident Societies Acts, 1893 to 1928, the Friendly Societies Acts, 1896 to 1929, and the Industrial Assurance Acts, 1923 to 1929, and with the rules of the societies whose accounts are submitted to them for audit.

4. No Public Auditor may audit the accounts, balance sheet or Annual Return of any society or branch in which he holds any other office. Subject to this he must not refuse to audit the accounts of any society or branch which is registered under either the Friendly Societies Acts or the Industrial and Provident Societies Acts, unless he obtains the authority of the Registrar.

5. The Auditor must verify the Annual Return with the accounts and vouchers relating thereto, and must have regard to the rules of the society, and either sign the Annual Return as found by him to be correct, duly vouched, and in accordance with law, or specially report to the society in what respects he finds it incorrect, unvouched, or not in accordance with law. Where a special report is made, the Auditor should see that the certificate to the Annual Return is altered accordingly. He must initial any alterations required in the Annual Return.

6. The maximum fees allowed to be charged for auditing are set out below. These do not include travelling expenses, and additional fees may be charged, by arrangement with the society, for work which is outside the scope of audit.

(*a*) Societies registered under the Friendly Societies Acts except Working Men's Clubs and Collecting Societies—

	£	s.	d.
Not exceeding 3,000*l.* of gross receipts	3	3	0
Exceeding 3,000*l.*, for every 1,000*l.* in excess up to 10,000*l.*	1	1	0
Above 10,000*l.*, fee to be fixed by special arrangement.			

(*b*) Working Men's Clubs registered under the Friendly Societies Acts and Clubs registered under the Industrial and Provident Societies Acts—

	£	s.	d.
Where receipts and payments added together do not exceed 2,000*l.*	3	3	0
Exceeding 2,000*l.*, for every 2,000*l.* in excess . . .	1	1	0

(*c*) Collecting Societies—

	£	s.	d.
Where receipts and payments taken together do not exceed 1,000*l.*	5	5	0
Exceeding 1,000*l.*, for every 1,000*l.* in excess up to 50,000*l.*	2	2	0

(*d*) Industrial and Provident Societies except Agricultural and Fishing Societies and Clubs—

	£	s.	d.
Not exceeding 3,000*l.* of gross receipts	3	3	0
Exceeding 3,000*l.*, for every 1,000*l.* in excess up to 10,000*l.*	1	1	0
Above 10,000*l.*, fee to be fixed by special arrangement.			

(*e*) Agricultural and Fishing Societies registered under the Industrial and Provident Societies Acts—

	£	s.	d.
Not exceeding 2,000*l.* of gross receipts	2	2	0
Exceeding 2,000*l.*, for every 1,000*l.* in excess up to 10,000*l.*	1	1	0
Above 10,000*l.*, special arrangement.			

7. Every Public Auditor must send a return of his audits, in the prescribed form, to the Registrar of Friendly Societies not later than 31st January. For the purposes of this return, the Auditor should keep a record of the registered names and numbers of societies, classified as in paragraph 6 above, their receipts and payments, and the audit fees and additional charges (if any).

8. A Public Auditor who solicits audits by advertisement, circular, or otherwise, or by offering commission or other inducement to any person, or who acts as Auditor at the request of a person who has been appointed as Auditor but is not qualified to act, will be struck off the list of Public Auditors.

Note. The Guide Book of the Registry of Friendly Societies by the Chief Registrar of Friendly Societies and Industrial Assurance Commissioners should be read by all Public Auditors.

IV. HOSPITALS AND CHARITIES. The appointment is usually made by the governing body of the hospital or charity. As regards hospitals, the Auditor should be familiar with a publication known as "Revised Uniform System of Hospital Accounts" as adopted by the King Edward's Hospital Fund for London, the Metropolitan Hospital Sunday Fund and the Hospital Saturday Fund, and with the conditions laid down in the publication. The War Charities Act, 1916, should be read, also the regulations made by the Charity Commissioners pursuant to Section 4 of the Act.

(But see under VARIOUS CLASSES OF AUDITS, page 227.)

V. PARTNERSHIPS. The Auditor is appointed by the partners and remuneration fixed by them. As to his duties, see under PARTNERSHIPS, page 217.)

The Limited Partnerships Act, 1907, Section 6, Subsection 1, gives power to a limited partner to employ an Auditor to inspect, as his agent, the books of a firm in which he is a limited partner, and examine into the state and prospects of the partnership business.

The remuneration in the cases of IV and V is a matter of arrangement, but much of the work connected with hospitals and charities is done either voluntarily or for a nominal fee.

COUNTY COUNCILS, CORPORATIONS, ETC. The appointment of an Auditor is usually made and the remuneration fixed by the Council.

AUDITORS OF COMPANIES

The Auditor of a company should make himself fully conversant, as the case may be, with—

1. The special Acts of Parliament incorporating the company.
2. Memorandum and Articles of Association of a limited company.
3. The rules and regulations of Friendly Societies and the like.

The following legal cases relating to the law as laid down by the Court should be carefully studied.

CASES

An Auditor had prepared the private accounts of income and expenditure of a baronet for thirteen years, and was paid for some years an annual fee of fifty guineas, and subsequently an annual fee of thirty-five guineas. On 22nd May he was informed the engagement would terminate on 30th June, but he contended the notice was insufficient. For the defence it was contended that the engagement was not a yearly one, although the amount was paid annually, and defendant was not entitled to notice. £18 7s. 6d. was paid into Court. It was held by Rentoul, J., sitting as Judge of the City of London Court, that judgment must be for the plaintiff for the full amount claimed, with costs.—*Homan* v. *Quilter*, 1908, Acct. L.R. 25.

A claim for compensation by the Auditors of a building society for damages owing to the loss of their appointments through the suspension of the society was referred by the Judge to Chambers. The parties subsequently agreed, subject to the Judge's sanction, for the Auditors to receive each an agreed sum by way of compensation and the costs of the proceedings.—*Re The Birkbeck Permanent Benefit Building Society*, 48 Acct. L.R. 41.

In *Litchfield & Sons* v. *Markus* (reported in *The Accountant*, Vol. XII, p. 676) the plaintiffs agreed, in December, 1885, to audit the defendant's books for £50 a year. They completed the audit for the year ending 31st December, 1885, in the following March,

and claimed their fee. The defendant contended that the £50 claimed was for a year's work, and was not due until a year from the date of the contract. His Honour Judge Coventry ruled that the contract meant £50 for a year's services, and that the action had been brought too soon.

Section 91 of the Companies Clauses Consolidation Act, 1845, provides that the remuneration of the Auditors shall, unless otherwise provided by the special Act of Parliament, be settled by a general meeting of the company, and it has been decided that Auditors appointed under this Section cannot recover any other remuneration than that fixed upon at a general meeting of the company.—*Page and Bishop* v. *Eastern and Midlands Railway Co.* (1884), 1 Cab. & El. 280.

Opinion of Counsel on Table A, Clause 83, *scheduled in the Companies Act,* 1862

The name or style under which a firm carries on business is merely a conventional name applicable to those persons only who are members of the firm on each occasion when the name is used. If, therefore, one person, Smith, is trading under the firm of "Smith, Jones & Co," he will be one Auditor within the meaning of Clause 83, Table A, of the Act of 1862. If two persons, Smith and Jones, are carrying on business under that style, they will be "more Auditors" within the meaning of the clause.

Such resolution as referred to would include Robinson and Brown, if they were members of the firm at the time the resolution was passed. It could always be shown in evidence that they were at that time partners in the firm of "Smith, Jones & Co."—*Carruthers* v. *Sheldon* (1815), 6 Taunt. 15; *Bass* v. *Clive* (1815), 4 M. & S. 13.

Newton v. *Birmingham Small Arms Co., Ltd.*, [1906] 2 Ch. 378, 22 T.L.R. 664

In this case it was held that Articles of Association which would limit the powers of the Auditor of the company are *ultra vires.*

Buckley, J., in his judgment, said—

In February last this company passed special resolutions the short substance of which is that the Directors may, under defined circumstances, set aside (without disclosing the fact) out of the profits sums to form an "internal reserve fund"—a sort of secret service fund—and that this fund need not be shown in or disclosed by the Balance Sheet, and no information need be given to the shareholders as to its amount, investment or application; that the Directors may invest it as they think fit without being liable for loss in consequence of such investments; that they may apply it for any purposes which they consider will advance the interests of the company; and that, while the particulars as to this fund are to be disclosed to the Auditors, it is to be the Auditors' duty not to disclose any information with regard to it to the shareholders or otherwise.

If the Balance Sheet be so worded as to show there is an undisclosed

asset, the existence of which makes the financial position better than shown, such a Balance Sheet will not, in my judgment, be necessarily inconsistent with the Act of Parliament. Assets are often, by reason of prudence, estimated, and stated to be estimated, at less than their probably real value. The purpose of the Balance Sheet is primarily to show that the financial position of the company is at least as good as there stated, not to show that it is not or may not be better. The provision as to not disclosing the internal reserve fund in the Balance Sheet is not, I think, necessarily fatal to the special resolutions.

A principal question in this case, I think, is whether it is a compliance with the words of the Companies Act that the Auditors shall report that they have examined the accounts as to the internal reserve fund, that they are satisfied with them, and that the funds have been employed in manner authorized by the company's regulations, or whether there will be default in complying with the Act if they do not go on to say how the fund has been employed. In my judgment such a report would be a sufficient report within the Act if the Auditor is *bona fide* satisfied that in making this report, and nothing further, he is truly reporting as to "the true and correct view of the state of the company's affairs."

But the special resolutions to not stop there. They provide that it shall be the duty of the Auditor not to disclose any information with regard to this fund to the shareholders or otherwise. It is, I think, inconsistent with the Act of Parliament that the Auditor should be bound, even when he thinks that the true state of the company's affairs is affected by facts relating to the internal reserve fund, to withhold all information with regard to the same from the shareholders. If, for instance, the Directors had invested the internal reserve fund upon investments which might involve the company under certain circumstances in enormous loss, the Act, I think, requires that the Auditor shall be at liberty and be bound to report that fact.

Any regulations which preclude the Auditors from availing themselves of all the information to which under the Act they are entitled as material for the report which under the Act they are to make as to the true and correct state of the company's affairs are, I think, inconsistent with the Act.

His Lordship granted an injunction to restrain the company from acting on the special resolution, and ordered the company to pay the costs.

Taylor and Others v. *Eustace Miles Foods* (1921) *Ltd. and Others* (1932), 76 Acct. L.R. 19

The plaintiffs sought an injunction to restrain the defendants from laying before the adjourned annual general meeting of the defendant company any Balance Sheet or Profit and Loss Account other than those audited by the plaintiffs with their report attached thereto, and further to restrain the defendants from excluding the plaintiffs from the adjourned meeting. The plaintiffs considered it to be their duty, having audited the accounts of the company and made a report, to insist that the Balance Sheet with their report should be laid before the company at the general meeting. The defendants wished to submit a revised Balance Sheet, audited by another firm.

Eve, J., said—

No court could say it was the Directors' duty to put forward a Balance Sheet which it was now admitted could not be justified and that they should

be prevented from submitting a Balance Sheet showing the true position. The most any court could do would be to say the Directors must explain the position to the shareholders and make a complete and full disclosure of all the circumstances. In the long run an honest disclosure was far more profitable than a partial disclosure.

On the defendants' undertaking that the old Auditors should have the opportunity of attending and making a statement to the Adjourned Meeting, the court did not see its way to make any order on the motion.

Note. This case may be compared with *re Allen Craig & Co. (London) Ltd.*, [1934] Ch. 483 (see page 138).

Cuff v. *London County Land & Building Co., Ltd.*, [1912] 1 Ch. 440

The Secretary of the company having been guilty of defalcations, by which loss was occasioned to the company, the Directors alleged that the company's Auditors had by negligence in the performance of their duties conduced to these defalcations and refused to give them access to the company's books for the purpose of audit. The Auditors thereupon brought an action against the company and the Directors, claiming a declaration that they, as Auditors, were entitled at all times to access to the company's books, and an order for access thereto. The time having arrived when, in the ordinary course, the audit of the company's accounts by the plaintiffs should be proceeding for the purposes of the next annual general meeting, the plaintiffs made an interlocutory application in the action for an order that the defendants should give them access to the books, and Eve, J., made a mandatory order to that effect on the ground that the Auditors had a statutory right of access to the books.

Held by the Court of Appeal, that it was a question for the judicial discretion of the Court whether the right of access to the books claimed by the plaintiffs should be enforced by a mandatory order, and that such an order ought not, under the circumstances of the case to have been made upon an interlocutory application, and without any steps to ascertain whether the company were desirous that the plaintiffs should continue to act as Auditors or not, and therefore the appeal must be allowed.

This decision may be overruled by Section 132 (3) of the Companies Act, 1929.

COPYRIGHT IN AN ACCOUNTANT'S REPORT

Chantrey, Chantrey & Co. v. *T. H. Dey* (1912), Acct. L.R. 9

It appears that the plaintiffs had been employed by a third party to make an examination of the defendant's securities. After doing so they issued a report to their clients. At a later date the plaintiffs were registered as the proprietors of the copyright

in the report. In the meantime the defendant had published an advertisement in which he included the plaintiffs' report to the third party. Mr. Justice Warrington in the course of his judgment said that it was contended on behalf of the defendant that the plaintiffs were employed to write this report as a portion of a periodical called *The Looking Glass*, and that they had been paid for it on the terms that the copyright should belong to the proprietor, and that they had been paid by the proprietor for that portion of the article, and that accordingly the copyright was vested in the third party, and that, therefore, the plaintiffs were not in a position to sue the defendant, who admittedly had infringed the copyright.

His Lordship, after referring to the provisions of the Copyright Act, 1842, and the authorities, said that he had come to the conclusion that the sole and exclusive liberty of publishing and multiplying the report had passed to the third party and that the plaintiffs had not reserved to themselves the right of separate publication and therefore that the action failed and must be dismissed with costs.

AUDITORS' AND ACCOUNTANTS' REMUNERATION. LIEN ON BOOKS FOR AUDITORS' CHARGES

A distinction is drawn between the rights of accountants when acting in an accounting capacity and when acting as Auditors. An Auditor cannot have a lien over the statutory books of a limited company. An accountant may have a lien but not always a very effective one. The following case defines the distinction and also the limit of a lien.

Herbert Alfred Burleigh v. *Ingram Clark, Ltd.*
(1901), 27 Acct. L.R. 65

In this case the Auditor of the defendant company was asked to hand over the account books of the company which were in his custody, as a matter of convenience, to the Receiver appointed in a debenture-holder's action. Mr. Justice Joyce said—

> Apart from other matters, it was clear the Auditor had no right to keep the Shareholders' Register, as that was a book which the company must keep for public inspection, and he must therefore give it up. That was not an account book. As to the Articles of Association, he could not see that the Article relating to the Auditors gave him any lien whatever on the books. At present he was of opinion no book of the company ought to leave the company's office.

Mr. Justice Joyce asked whether, if the Auditor would return the books at once, the receiver would be willing to give the Auditor a personal undertaking to pay whatever it might be found he was entitled to. Of course, he did not say that the Auditor was entitled to a lien.

His Lordship's judgment was as follows—

He said that the affidavits filed showed that the respondent claimed a lien, not as Auditor, but as Accountant. In his opinion the question of an Auditor's lien did not arise, and, had it done so, he considered that an Auditor had no such lien; but that point he did not now decide. In respect of the Share Register, the Accountant had no possible lien on that, but he held that he was entitled to a lien on such books only as he had actually worked upon, in respect of his proper remuneration for work upon those books only. If the parties did not agree upon the sum, there must be an inquiry. Each side would pay its own costs.

CHAPTER XIII

INVESTIGATIONS

INVESTIGATIONS form a considerable part of a professional Accountant's practice, and it is appropriate to consider the subject in a work on auditing. Investigations arise chiefly in the circumstances outlined in this chapter and a summary is given of the main points which require attention.

I. *Investigation for the purpose of certification of past profits for prospectuses issued by public companies registered under the Companies Act*, 1929, *or of past profits of a business of which a company contemplates the purchase.*

This class of investigation is one in which the Accountant undertakes a very special responsibility, for the investing public will have regard to his report in determining whether or not to invest their money in the issue. Further, the Accountant may be dealing with Directors who, by reason of their own faith in the business for which the money is required, or by reason of their anxiety that the issue should not fail, are apt to desire that the most hopeful interpretation should be placed on past results. Again, the Directors may be acting fraudulently, or with a disregard of their duties and obligations to the public and their shareholders.

The Accountant therefore must not fail to exercise the greatest care in his examination of the accounts, nor should he respond to any pressure to work to an impossible schedule of time, nor accept any suggestion that delay arising from excessive care will jeopardize the issue. Persons who leave things to the last minute are apt to impose on others the responsibility for making up the lost time, and many an Accountant has had to produce his report under this pressure. Recent cases in the Courts have called public attention to the importance of prospectuses, and show very clearly how great is the responsibility which the Accountant undertakes.

Part II of the fourth Schedule to the Companies Act, 1929, deals with reports to be set out in a prospectus and reads as follows—

1. A report by the Auditors of the company with respect to the profits of the company in respect of each of the three financial years immediately preceding the issue of the prospectus, and with respect to the rates of the dividends, if any, paid by the company in respect of each class of shares in the company in respect of each of the said three years, giving particulars of each such class of shares on which such dividends have been paid and particulars of the cases in which no dividends have been paid in respect of any class of shares in respect of any of those years, and, if no accounts have

been made up in respect of any part of the period of three years ending on a date three months before the issue of the prospectus, containing a statement of that fact.

2. If the proceeds, or any part of the proceeds, of the issue of the shares or debentures are or is to be applied directly or indirectly in the purchase of any business, a report made by accountants who shall be named in the prospectus upon the profits of the business in respect of each of the three financial years immediately preceding the issue of the prospectus.

But see also Section 35 of the Act.

The Accountant should make an examination of the Balance Sheets and Profit and Loss Accounts for the requisite number of years, and in particular should ascertain from the Profit and Loss Accounts—

(i) Whether there are any profits or losses of an exceptional or non-recurring character, or of a Capital nature. It is usual, and in most cases necessary, to adjust the profits by deleting these exceptional items.

(ii) Interest received or paid. The basis of finance of the company will probably be altered by the subscription to the issue, in which case interest paid or received in the past will be no guide to the corresponding items in the future. Such items are not normal and would not be taken into account in computing goodwill. If the proceeds of an issue of capital are to be applied to pay off loans, interest on the latter would cease to be payable.

(iii) The amount of income tax debited. Income tax is not deemed to be a charge on, but an appropriation of the profits. The amount payable, year by year, varies and, since income tax is not ordinarily assessed on the profits of the actual year, it is not directly related to the profits. Income tax is deducted from dividends paid and this deduction goes to the credit of the Income Tax Account. Apart from these variations there is the change which is made from time to time in the rate of tax. For these reasons it is usual to state profits before charging income tax.

(iv) Depreciation charged. This may have been excessive, or too little. In any case the amount of depreciation to be written off in the future may be greater or less according to the values placed upon the assets to be acquired as set out in the prospectus.

(v) The amount of the Directors' fees. This figure should include income tax if the fees are paid free of tax. Payment of directors' fees free of tax requires the authority of a specific provision in the company's Articles. The prospectus sets out the fees which it is proposed to pay in the future, and these may differ from those paid in the past. Fees charged in the accounts may, therefore, be added back.

These adjustments must be referred to, either specifically or in general terms, in the report submitted by the Auditor or

Accountant, so that the intending investor may know on what basis the profits or losses quoted have been computed. The further details furnished in the prospectus itself will enable him to ascertain what adjustments to make for future charges and other items so disclosed. The purpose of the report is to enable the investor to judge by past results what, *mutatis mutandis*, the company may be expected to do in the future. He should therefore be put in possession of evidence to enable him to do so, and for this reason items arising in the past which will not recur should not be included, and the prospectus should furnish such information as will enable him to take into account items which will arise in the future but have not arisen in the past. It is not the duty of the Accountant, in his report, to give a forecast of the likely profits which the company will earn, nor is it proper for him to do so. He deals with facts as shown by the Accounts of the company in respect of its past trading. He should not give averages without giving in detail the figures from which the average is computed.

Statements in this book as to the work to be performed at an audit apply with equal force in the case of an examination of accounts for prospectus purposes. In the case of a report under Part II (1) of the fourth Schedule (*supra*) the investigating Accountant will himself have audited the accounts, but this may not be the case under Part II (2). If he has audited them his work will be simplified, but in any case he should make a particularly careful examination of the accounts of the last period to ensure that there has been no "window-dressing" with the prospectus in view, more especially by the omission of liabilities, by an unduly optimistic view of assets and items of profit, or by a too liberal valuation of stock. Again, it should be seen that the later years do not show unduly good results because earlier years have been burdened with excessive, though at the time prudent, provision for future contingent losses.

II. *The valuation of debentures, stocks or shares as between a willing buyer and seller, or for probate.*

The first point is to ascertain whether there is sufficient security to cover the capital sums involved, after making a reasonable valuation of the assets and deducting the liabilities. This point applies equally to the valuation of debentures, stocks, and shares.

The next point is to ascertain the actual profits and what may reasonably be considered to be the divisible profits, and therefore the rate of dividend, and the possibility of the rate being maintained or increased or decreased. Having regard to the return receivable from a first-rate security, the question is, what price

would be given to secure a higher return with what may be a less stable security. If, for example, a return of 5 per cent is required and the dividend payable is 5 per cent, the value would be par if security is satisfactory. If a return of 7 per cent is required, then the value would be $\frac{100}{7} \times$ £5 %, or say £71 8s. 7d. per £100 to be acquired.

The conditions attaching to the debentures, stocks and shares should also be considered. The official view is that a restriction on the right of transfer does not affect valuation for probate, but everyday experience shows that it does for all purposes of valuation. As regards preference shares, the Articles of Association should be studied. They may provide that on a winding-up the preference shares are to be paid off at par, in which case the shares will not as a rule be considered to be worth more than par. Many debatable points may arise in individual cases, requiring a considered and impartial judgment.

III. *Claims under an insurance policy covering consequential loss.*

As this is a question of account, a professional Accountant is usually appointed either as sole arbitrator, or one of two arbitrators with an umpire, to determine the amount of the claim.

The purpose of the insurance is to cover the loss of profits arising as a result of a fire. The extent of loss of profits varies naturally with the magnitude of the fire but also with the nature of the business. Loss will arise not only by reason of damage to premises and consequent interruption of business but also by reason of loss of stock, ready or being prepared for sale, which will have to be replaced. Apart from loss of the stock, there will probably be a certain loss of trade through stock not being available when required. Again a certain increase in working expenses may be caused, or on the contrary there may be some saving owing to the interruption of work.

The insurance, which is usually taken out for a specific period—probably year by year—indemnifies the insured against—

(*a*) loss of turnover,

(*b*) increase in cost of working,

during a period defined in the policy and known as the period of indemnity.

The amount of the insurance is stated in the policy and no claim can exceed this. If the amount of the loss is greater, the principles of average are applied and only a percentage falls upon the underwriters, the insured bearing the rest. It is important, therefore, to insure for an adequate amount.

Attached to the policy is a schedule setting out the particulars of the insurance. There are also special conditions, in common

form, printed on the policy which have to be observed in determining the amount of the claim. The usual conditions are as follows—

1. In this policy the following words and expressions shall have the meanings hereunder attached to them respectively, viz.—

NET PROFIT. The Profit arising from the trading of the Insured in respect of the Business in the Premises after proper provision has been made for

(a) All fixed and other Charges.

(b) All Capital Receipts and Accretions and all Outlay properly chargeable to Capital, and

(c) Depreciation.

FINANCIAL YEAR. The year ending on the day to which in the ordinary course the yearly accounts of the Business are made up.

2. This Policy does not cover

(a) Loss occasioned by or happening through

(i) Earthquake, Subterranean Fire, Riot, Civil Commotion, Foreign Enemy, Military or Usurped Power, or Explosion (whether the explosion be occasioned by fire or otherwise).

(ii) The destruction of or damage to property through its undergoing any process involving the application of heat or through its own spontaneous fermentation, heating or combustion other than of Coal and (at Gas Works) of other materials used in the production of gas.

(iii) The destruction of or damage to any dynamo, motor or other electrical machine or apparatus through its own over-running, excessive pressure, short-circuiting or self-heating.

(b) Fines or Damages for late completion or non-completion of orders or other breach of Contract or Penalties,

except in so far as any of such Contingencies or Matters may be specially mentioned in and expressed to be insured by the Policy.

3. The Policy shall be voidable

(a) In the event of misrepresentation, misdescription or non-disclosure in any material particular.

(b) If Insurance against Fire be not maintained upon the property of the Insured at the Premises.

(c) In any of the following cases unless in every such case the assent or sanction of the Company be signified by memorandum signed by or on behalf of the Company, viz.—

(i) If the Insured effect any additional Insurance to cover the subject matter of this Policy or any part of it.

(ii) If, after the risk has been undertaken, the danger of loss be increased from any cause whatsoever; or if the rate for the ordinary Fire Insurance risk be increased and notice thereof be not given to the Company.

(iii) If the Interest in the Business pass wholly or in part from the Insured otherwise than by Will or operation of Law, or

(iv) If the Business shall be liquidated or discontinued after the occurrence of the Fire otherwise than temporarily pending reoccupation of the Premises.

4. On the occurrence of a Fire in consequence of which a claim is or may be made under this Policy the Insured shall forthwith give notice thereof in writing to the Company and shall use due diligence and do and

concur in doing and permit to be done all things which may be practicable to minimize any interruption of or interference with the Business and to avoid or diminish the loss. The Insured shall at his own expense deliver to the Company a claim in writing for the loss calculated in accordance with the terms and conditions of this Policy, and shall produce and give to the Company such properly audited balance sheets, account books, vouchers, plans, specifications and such other detailed particulars, proofs and explanations as may be from time to time reasonably required, together with, if demanded, a statutory declaration in support thereof. No indemnity under this Policy shall be payable unless and until the Company or Companies insuring the property of the Insured at the Premises against Fire shall have paid for or admitted liability in respect of the destruction of or damage to the said property.

5. If at the time of any loss under this Policy there shall be any other insurance covering the same subject matter or any part of it the Company shall not be liable for more than its rateable proportion thereof.

6. If the claim be in any respect fraudulent or if any fraudulent means or devices be used by the Insured or anyone acting on his behalf to obtain any benefit under this Policy or if any loss be occasioned by the wilful act or with the connivance of the Insured all benefit under this Policy shall be forfeited.

7. Any claimant under this Policy shall at the request and at the expense of the Company do and concur in doing and permit to be done all such acts and things as may be necessary or reasonably required by the Company for the purpose of enforcing any rights and remedies or of obtaining relief or indemnity from other parties to which the Company shall be or would become entitled or subrogated upon its paying any loss under this Policy, whether such acts and things shall be or become necessary or required before or after his indemnification by the Company.

8. In adjusting a claim account shall be taken of any variations in the Business and allowance made for any additions or deductions in respect of Turnover Output or other Standard employed in the Policy which having regard to any extraordinary circumstances ought to be made.

9. In the event of the earnings of the Business for the financial year next preceding the Fire or other period specified in the Policy being insufficient to meet fully the amount of Standing Charges relating to such period the Insurance shall only apply to the extent to which the Standing Charges shall or would have been met by such earnings.

10. All differences arising out of this Policy shall be referred to the decision of an Arbitrator to be appointed in writing by the parties in difference or if they cannot agree upon a single Arbitrator to the decision of two Arbitrators, one to be appointed in writing by each of the parties within one calendar month after having been required in writing so to do by either of the parties, or, in case the Arbitrators do not agree, of an Umpire appointed in writing by the Arbitrators before entering upon the reference. The Umpire shall sit with the Arbitrators and preside at their meetings, and the making of an Award shall be a condition precedent to any right of action against the Company. After the expiration of twelve months from the termination of the period in respect of which indemnity is expressed to be recoverable the Company shall not be liable in respect of the relative claim unless it shall in the meantime have been referred to arbitration.

It is necessary to deduce the profits and the standing charges by reference to the books and in accordance with the schedule and special conditions.

CASE

By a policy of insurance against fire on business premises an insurance company agreed to pay to the insured, in the event of damage by fire to their property on account of annual net profit, an agreed percentage on the amount by which the turnover in each month after the fire should in consequence of the fire be less than the turnover for the corresponding month of the year preceding the fire. The policy further provided that the amount of all losses under the policy should be assessed by the insured's Auditors. During the currency of the policy property of the insured was damaged by fire. The Auditors gave certificates stating the difference between the turnover for the months after, and the corresponding months in the year before the fire, and the percentage payable. An arbitration was held to determine the amount payable under the policy. The Auditors' certificates were put in evidence, and a member of the firm of Auditors was called as a witness by the insured and stated that when he gave the certificates he was satisfied that the losses of turnover stated therein were in fact sustained in consequence of the fire.

Held, that the assessments of the Auditor were conclusive evidence of the amount of the loss recoverable under the policy, unless it were shown that the Auditor had misdirected himself in point of law or had omitted to take into consideration some material fact; and that the Auditor might be cross-examined, and the insurance company might call direct evidence, to show that the Auditor had omitted to take into consideration the fact that the losses of turnover were wholly or in part due to other causes than the fire, but not to show that the Auditor's conclusions of fact were erroneous.—*Recher & Co.* v. *North British and Mercantile Insurance Co.*, [1915] 3 K.B. 277.

IV. *The proposed acquisition of a share in a business, whether as a partner or sleeping partner, or shares in an established company, or a proposed advance by a bank or other body or by an individual.*

In addition to ascertaining the assets and liabilities and profits as disclosed by the books, the Investigator should consider the following points—

(1) The conditions of the agreement proposed to be made between the respective parties.

(2) The nature of the business, the outlook so far as it can be gauged (including the possibility of supersession in, for example, a business working a patent or a secret process), and the prospect of keen competition in the future.

(3) The total capital, including borrowed capital, in the business.

(4) Whether there is a lease of the premises occupied, and the terms and conditions of the lease.

(5) The financial position and what additional capital is sufficient to keep the business liquid.

(6) What books are kept, and whether they are audited.

(7) How many persons connected with the business have a technical knowledge of the business and are qualified to carry on in case of need.

(8) What contracts are running for purchases and sales and whether they appear to be beneficial.

(9) Whether the sales include only trading sales in the ordinary course of business.

(10) Whether the debts are paid up promptly, and orders repeated, and whether all bad debts have been written off.

(11) Whether goods bought have been paid for promptly and the usual trade and cash discounts secured.

(12) What bills payable are outstanding and when they are due.

(13) How the stock is taken and valued, and whether there is an independent check on the stocktaking.

(14) What rate of depreciation is written off leases, plant and machinery, and whether this is adequate.

(15) What provision has been made in the accounts for outstanding rents, rates, and income tax. Who has prepared the income tax returns and whether there is any possibility of a claim by the Revenue for back duty, or, conversely, if a reclaim can be made.

(16) The percentage of gross and net profits on sales from year to year, over a number of years, noting whether the sales are progressive.

(17) How often the stock is turned over each year.

(18) What agreements exist with employees and the conditions attached thereto.

(19) Whether any part of the assets is mortgaged or pledged in any way.

(20) How the value of work in progress has been computed.

(21) The total wages paid and fixed charges, and the percentage of fixed charges to wages from year to year. The number of hands employed and the average wage.

In the case of companies—

(1) Obtain a copy of the Memorandum and Articles of Association. Ascertain the rights of preference and ordinary shareholders, who the holders are, and what are their respective voting powers.

(2) Ascertain what debentures are outstanding and the date of redemption.

(3) Obtain a list of the Directors, ascertain their powers and their remuneration, the provisions as to qualification shares and conditions as to re-election of Directors.

(4) Ascertain the company's borrowing powers, and how far they have been exercised.

(5) Inspect the Register of Mortgages and if thought necessary the Register of Charges at Bush House.

(6) Examine the minutes of the meetings of Directors.

Where the books have been examined and the accounts reported upon by responsible Auditors, the Investigator may assume that the books and accounts are correct, and confine his attention to questions of principle and the possibilities of the situation, but he should make it clear that he has done so, as witness the cases quoted at the end of this chapter.

V. *Investigations in the case of fraud whether discovered or suspected.*

The Investigator may have to go back to the original records such as advice notes, delivery notes, stock records and invoices.

(1) He should examine closely the cash receipts and payments, verifying the casts and comparing the receipts and payments with the bank pass-book, and eventually agreeing the balance shown in the Cash Book with the balance shown in the banker's pass-book or statement and certified by the bankers to the investigator. He should vouch the payments. He should examine the petty cash, agreeing the amounts advanced to petty cash with the advances to petty cash appearing in the principal Cash Book from which the petty cash is fed, and he should ascertain how far the amounts advanced to petty cash are necessary to meet the expenditure.

(2) He should examine the statements of the various debtors and creditors and compare them with the relative Ledger balances.

(3) From the advice notes and delivery notes and invoices and stock records he should ascertain whether all sales and purchases have been recorded in the books, and whether the purchases are genuine and relate to the business. How far this procedure can be carried out depends upon the way in which the books and records have been kept, but the statements from the debtors and creditors will usually give a key to what is missing.

(4) *Cash Sales.* The original records, if available, should be examined and the amounts of the sales agreed with the cash received.

(5) All expenses charged should be examined to show whether they are genuine or not.

(6) Drawings by partners and sums paid to Directors should be confirmed by the recipients.

(7) Counterfoil receipts may be of use, provided the receipts are not made out by the recipient of the cash; but if they have been made out by him they may have been manipulated, and they are not, therefore, conclusive evidence.

(8) The Bills Receivable and Bills Payable Books should be examined to verify that the bills receivable have been encashed or are on hand, and that the bills payable relate to the business and have been duly charged up to the respective creditors. An endorsed cheque should not be accepted as evidence of payment without conclusive evidence as to the nature of the payment.

(9) The Wages Book should be verified with the assistance of someone who knows the facts as to the actual employees.

The Investigator should so marshal his conclusions that if called upon to give evidence against a defaulting party, he may be able to do so in a clear and decisive manner.

VI. *Alleged negligence or lack of skill by Auditors.*

From time to time proceedings have been brought against Auditors, not on questions of principle, but on allegations that owing to negligence or lack of skill they have failed to detect frauds by employees, which, owing to the absence of adequate control, had escaped the attention of the Directors or managers.

Professional Accountants are frequently asked to give evidence in such cases for one side or the other. As the reported cases show, very diverse views have been put forward in evidence for the plaintiff or defendant.

There is a tendency on the part of some witnesses, lacking the judicial mind, to take their view of the issue in the light of a close investigation made by them after the frauds have been discovered, and not to take sufficiently into account the position of the Auditor carrying out his duties at the time, in good faith, without any grounds for suspicion and not as a detective.

It is considered by many to be detrimental to the standing of a profession that individual members of the profession should out-face each other in the witness box on questions which do not relate to debatable matters of principle. Accountants are becoming more and more reluctant to be drawn into these proceedings, especially as many of the cases are capable of a reasonable settlement if approached with a desire to reach a fair conclusion. This reluctance does not indicate any diffidence in expressing views on the subjects in dispute, but because the Accountant realizes that it is frequently impossible to determine how far, in the light of circumstances existing at the time, another Accountant may have been negligent in the work which he performed or omitted to perform. On the other hand, the public are entitled to protection and to have the opportunity of

calling expert evidence to establish their case, and the accountancy profession should not adopt an attitude which has the effect of depriving them of this opportunity provided the claim is of a reasonable and fair character.

CASES

Short & Compton v. *Brackett* (1904), Acct. L.R. 85

The plaintiffs sued the defendant for payment of their fees for the preparation of accounts of a business to show the amount of profit and goodwill. The defendant counterclaimed for damages for alleged negligence on the part of the plaintiffs. A clerk had been defrauding the defendant and he thought the plaintiffs should have discovered the fraud. The clerk had made out the wages for a larger sum than was in fact payable and put the difference in his own pocket.

The plaintiffs pleaded that they were not responsible for the entries in the books; their duty was to arrive at the result as shown by the books and that the defalcations were due to the careless way in which the defendant kept his accounts.

His Honour Judge Tindal Atkinson held that, having regard to the object for which they were employed, the plaintiffs were entitled to assume that the figures appearing in the defendant's books as paid for wages were correct, and in view of the fact that at the time there was no suspicion of any defalcations by the defendant's clerk alluded to, he thought there was no negligence on their part. Therefore judgment would be for plaintiffs on the claim with costs, and the counterclaim would be dismissed with costs.

Colmer v. *Merrett, Son and Street* (1914),
50 Acct. L.R. 21

This action was brought by the plaintiff claiming damages for alleged negligence of the defendants who had investigated a business and reported favourably upon it. The plaintiff had invested money in the Company, most of which he lost.

Lush, J., said—

Negligence meant in law breach of duty which one person owed to another who paid him to render certain services by not bringing to bear that reasonable skill and care which a professional man impliedly undertook that he would use.

The burden was upon the plaintiff to prove that the work the defendants did in the preparation of the October Balance Sheet was negligent. The defendant did not suggest that he undertook a full audit, while the plaintiff said in substance that he did. One of the first questions for the jury, therefore, was what was the real duty the defendant undertook. There was, of course, no charge of fraud against him. The report furnished by the defendant was of the greatest importance in the case, and, it seemed to him,

actually set out what was undertaken to be done. That was never demurred to. The plaintiff's solicitor did not write back and say that was not what the defendant agreed to do. The plaintiff said he had taken the figures as supplied by the Managing Director, and that again was not objected to either by the plaintiff of his solicitor. The plaintiff, also, must have known from the report of the shortness of time in which the statement was prepared. It was begun on Saturday and finished on Tuesday, and as to that the defendant had stated that a full audit would have taken three weeks. This question of time seemed very important, and if the Auditor was employed to check the Managing Director and to make a full audit, then two or three days did not seem a long time to do it in. But if the jury were of opinion that the defendant undertook to act as a check upon the Managing Director and advise the plaintiff what the position of the company was as an Auditor did when he made a full audit, they might properly think that the duty had not been fulfilled and there had been a breach of it. It was very unfortunate that a gentleman who was going to invest a considerable sum in a business should have been content with having the result of two or three days' work from an Auditor authorized to accept from the Managing Director his own view of what the stock was worth, instead of having the thing done with full care.

The jury returned a verdict for the plaintiff and assessed the damages at £250. Judgment was entered accordingly.

CHAPTER XIV

FRAUD IN ACCOUNTS

FRAUD by employees (the detection of which is considered by those without adequate knowledge to be the whole purpose of an audit) is in practice a relatively unusual occurrence. The successful perpetration of fraud is usually due to the difficulty in discovering some subtle classes of fraud, and the facilities available to those who are of a fraudulent disposition and are not adequately controlled by their Directors or principals. The Auditor is entitled to expect from his clients and their managers that all reasonable steps be taken to make the perpetration of fraud impossible or difficult, and they in their turn are entitled to expect from him skilled advice as to organization and expert checking which will minimize the chance of fraud and lead to its early discovery. An Auditor who fails to detect fraud where the exercise of reasonable skill would have done so, may be held to have been negligent in the performance of his duty. Some frauds, however, are of so complicated a character that an Auditor could not reasonably be held to be negligent in failing to detect them. Many frauds are discovered by the merest chance. This must necessarily be so where only a limited amount of checking is carried out in the audit, and sound internal control is lacking. As regards employees, frauds may be divided into two main classes—

1. Falsification of the books to mask misappropriations of cash.
2. Fraudulent dealings in stock, by misappropriation combined with falsification of records.

Certain features are common in the more elementary frauds, and discovery usually happens, either because early success induces the fraudulent clerk to continue his frauds on a progressively larger scale more difficult to conceal, or quite simply when a certain amount of cash has unexpectedly to be produced and the defaulter cannot produce it. A common practice in the case of misappropriation of cash is for the cashier to utilize the collections of the following day to make up a shortage of payment into the bank of the previous day. Payment into bank a day late may be reasonably explained, but, of course, the cashier has to exercise care each day so that the defalcation is adjusted in the paying in. This form of fraud is discovered if the defaulting cashier rashly takes a holiday or when the accounts are balanced and the cash is counted at the end of the financial period.

Directors should arrange, where possible, for a distribution of the daily routine work which will make fraud difficult. For

example, the cashier should not be in a position to tamper with the ledger accounts and, if possible, an independent record of cash as it is received should be made and agreed with the amount paid in.

A protection against misappropriation of petty cash is afforded if it is kept on the imprest system. (See VOUCHING AND VERIFYING THE CASH, Chapter V.) The Auditor should see that the amount of the petty cash in the cashier's hands bears a reasonable relation to the expenditure. If the cashier's balance is always largely in excess of the expenditure, he has an opportunity for misappropriating the surplus. This will only be discovered when the cash is counted. It may be found that the balance is made up largely of IOU's.

The Auditor should bear in mind that there is a natural inclination on the part of those who employ him to blame him if any defalcation occurs. He should, therefore, call attention to any defect in the system of accounting and control, and if he feels strongly about it, he may be well advised to disclaim, in writing, all responsibility for any loss which may be suffered by his clients if the defect is not remedied.

Manipulation of stock is a not uncommon source of fraud. The question of pilfering of stock can be dealt with by internal control. A falsification of stock may, however, be carried out for the purpose of inflating or deflating profits. This can only be done at the expense of the following year or years, for the closing stock of one year is the opening stock of the next, and a wrongful valuation only switches the profits or losses from one year to another. The falsification cannot last indefinitely owing to the interlacing relation between sales and stock.

A rough check can be made by the Auditor when the Trading Account is prepared, by calculating the percentage relationship of the various items, including gross profit, to sales. Large variations between one year and another should be inquired into.

In one case, at the end of the first year of a new company, the whole of the stock was taken at selling prices with the result that the year appeared to be phenomenally successful, and additional capital was issued at a premium. In the following year, the results were very different and on inquiry the cause was traced to the previous valuation of stock. The Directors realized that no profits could be made in the current year on sales of stock which had been valued at selling prices (as if sold), and that in fact the cost to sell that stock in the current year would be a charge on the profits arising out of any sales from material which was not in stock at the end of the previous year. Although as regards stock, an Auditor must usually rely very largely on certificates by responsible officials, it is obvious that a blunder of this kind,

which was due to ignorance on the part of the Directors and Secretary, should have been detected.

It may sometimes happen that the Balance Sheet and Profit and Loss Account are falsified by the Directors for the purpose of misleading the shareholders and the public. This, while not involving direct and immediate misappropriation, is usually done to enable the payment of unjustifiable dividends, and it may be to enable Directors to dispose of their shares at an enhanced and artificial price, or perhaps to induce the public to subscribe to a new issue of shares. This, however, is uncommon nowadays, for professional practice in the art of auditing and investigation has become more incisive.

Falsification of the accounts for the purpose of misleading shareholders and the public is a large question which does not admit of detailed treatment in this volume. It may be carried out by the more simple method of omissions of liabilities, over-valuation of assets, or falsification of the stock. On the other hand, the method employed may be more subtle and deep-seated and the Auditor will require to exercise all his skill and caution to discover it. In some cases the presentation of the accounts though not actually involving falsification may violate accountancy and commercial principles and be misleading. This will frequently place the Auditor in a difficult position, because he may not be able to point to something which is definitely false. In all such cases he should endeavour to persuade the Directors to act in accordance with his view, rather than qualify his report. As mentioned in Chapter II, qualification of the report should be regarded as a last resort.

It should be borne in mind that errors, whether by way of omission or commission do not always involve fraud, and may be genuine mistakes.

EXAMPLES

(1) The practice of counting cash in hand regularly on the last day of the year is not so effective as a surprise inspection at irregular dates. A very old instance is that of a toll-keeper who was allowed to retain a substantial sum in silver for the purpose of giving change. He had, however, misappropriated the money. In order to satisfy the Auditor at the end of the year, it was his practice to borrow the silver from a neighbouring publican. This practice continued for many years until the publican inconveniently died the day before the audit, when the fraud came to light.

(2) An invoice clerk received an invoice for £10, and in due course a statement for the same amount net. He altered the £10 on the invoice to £16, and procured a cheque from the cashier for

£16 by producing the invoice, saying that he was calling at the payee's office, and would hand him the cheque. At the payee's office he produced the statement for £10 with the cheque for £16, explained that a mistake had been made by the cashier, got the statement receipted, also £6 in gold to pay into "Petty Cash" to square matters. He then destroyed both the invoice and the statement, and pocketed the gold. On asking for a receipt, the Auditor was shown a cheque properly drawn and regularly endorsed by the payee and cleared through the payee's bank. He, however, asked for the corresponding invoice, but there was none. On his pushing inquiries further, the whole story came out, and proved to be the first of a series of similar frauds, to which a lack of systematic control had opened the door.

This illustrates the danger of accepting an endorsed cheque, however regular on the face of it, as a voucher without supporting evidence.

(3) At the request of the Inland Revenue Authorities a professional Accountant was asked to prepare the accounts of a partnership for taxation purposes. The books consisted of a Cash Book and a Sales Ledger. The only way to arrive at the purchases was to make a total of the payments to creditors, deducting the amount owing at the beginning of the year and adding the amount owing at the close of the year.

The Auditor took the precaution of comparing the payments in the Cash Book with the Bank Pass-book and found that many of the names in the Cash Book were false. The cheques drawn for the payments to alleged creditors were in fact made out in the names of the partners and cashed by them.

This emphasizes the importance of the names of the payees and not simply the numbers of the cheques being given in the Bank Pass-book.

(4) The Secretary of a company with many branches received daily considerable sums of cash which he was supposed to pay in daily to the bank. He misappropriated part of the cash, making up the discrepancy by using the remittances from the branches to fill up the gap. The delay which arose in crediting the remittances from the branches aroused suspicion and the fraud was detected, but the money had gone. Adequate supervision by the Managing Director would have rendered this form of fraud impossible. In a well-organized business the branch remittances would be made direct to the Bankers of the company at the head office or paid in to the credit of the company at a local branch for transmission to the bank of the head office.

CHAPTER XV

THE ACCOUNTS OF EXECUTORS AND TRUSTEES

THE audit of Trust Accounts requires a close knowledge of the law relating to trusts.

Section 22 (4) of the Trustee Act, 1925, provides that the trustees may have the accounts of the trust audited once in three years unless special dealings in the trust property make a more frequent audit advisable. The Auditors' fees are payable out of income or capital or are to be apportioned between income and capital at the discretion of the trustees.

A beneficiary or a trustee may apply to the Court for an audit to be carried out under Section 13 (1) of the Public Trustee Act, 1906. The Court will appoint a solicitor, a public accountant or the Public Trustee (or some person appointed by him) to carry out the audit, and the applicant may be required to provide security for the costs of such audit.

By a study of the Acts and cases, the Auditor should acquire a thorough knowledge of the rules and decisions relating to the distinction between capital and income, which must be strictly followed, including the apportionment between capital and income of rents and profits, dividends, receipts from timber, minerals, proceeds of sales, and interest accrued due or accruing at the date of death and of income tax, whether deducted at the source or levied under Schedules A, B, or D, also of the various outgoings including rates and taxes, rents, fire insurance, repairs, upkeep of mines, improvements, costs and expenses, and items which arise in exceptional cases.

The Auditor having mastered the facts as to any particular trust should ascertain which of the statutes and rules apply to the trust and see that effect is given to them in the accounts. The provisions of a trust may, however, be altered with the consent of the beneficiaries if all are of full age.

In the interests of both trustees and beneficiaries, it is most important that all trusts should be held to a strict audit. At the first audit, the assets and liabilities should be traced to the books from the Estate Duty Affidavit and Corrective Affidavits, if any, so as to ensure that the assets have all been accounted for and the liabilities settled. A summary should be made of the testator's will and codicils thereto, if any, and care taken that the provisions of the will are strictly observed. The rules of law as to capital and income must be strictly followed, except where expressly excluded by the will. Gains or losses arising on realization

of capital must be added to or deducted from the corpus of the estate. In the case of obscurely worded wills, or where there are wasting assets as to which the procedure is not governed by any legal precedent, the Court is asked for directions, and the Auditor should be provided with a copy of the directions.

The Auditor should see that the trustees have received all the dividends and interest on investments, rents and other income that ought to have been received and should check the dividend counterfoils with the books. He should examine brokers' contract notes as to realization of stocks and shares and re-investments, and should see vouchers for all payments.

It is advisable occasionally to see that the trustees have obtained an acknowledgment from an annuitant or a life tenant of the receipt of income paid direct to a banking account under a banker's order.

The Auditor should satisfy himself that all duties payable have been ascertained and paid, or brought into account. In these matters he will have the guidance of the Solicitor to the trust.

The Auditor should satisfy himself on the following matters.

INVESTMENTS

He should see that they are all authorized either by the will or other instrument creating the trust or by law. Bearer securities which if in registered or inscribed form would be authorized investments, may be held by trustees under Section 7 of the Trustee Act, 1925 (unless the instrument prohibits the holding of bearer bonds), on the condition that the bonds are deposited with a banker or banking company for safe custody. At the first audit it is advisable to inspect the bonds, but on subsequent occasions the certificate of the bailee can usually be accepted.

INCOME TAX

The Auditor should see that the testator had the full allowances for the year in which he died, and also that provision is made for any increased assessment that may arise in respect of the preceding year. If sur-tax is payable it should be seen that the last assessment has been made on the correct basis.

If there are any "free of tax" annuities he should see that the trustees obtain their share, under the rule in *Lefevre* v. *Pettit*, [1922] 2 Ch. 765, of any tax repayment that an annuitant obtains.

LEGACIES

The Auditor should see, in cases where a legacy is not free of duty, that the duty is deducted, or in the case of specific legacies,

recovered from the legatee. If on a free of legacy duty annuity payable out of the income of the estate, the duty is paid in advance under discount instead of by four annual instalments, this discount should be credited to income. On the death of an annuitant within five years, when the duty has been paid in advance under discount, a proportion of this duty can be recovered from the Inland Revenue and must be handed over to the annuitant's executors if the duty was originally paid by or recovered from him.

MARRIAGE SETTLEMENTS

Where one of the assets of a testator is a reversionary interest in his own marriage settlement which falls into the residue of his own estate on his death under a power of appointment or otherwise, the Settlement Deed and also the Estate Duty Account of the Marriage Settlement Trustees on Form No. C1 should be examined to see that all the assets have been included. If the settled property comprises two or more funds the Auditor should see that each fund has borne its own death duties.

In the case of marriage settlements containing what is known as the "After Acquired Property" Clause, the Auditor should obtain a statement from the parties to the settlement that any after acquired property has been brought in.

This clause is frequently overlooked, leading to serious complications; as, for example, where one of the parties has willed away property which is in fact caught by the settlement.

PAYMENT OF DEBTS

After payment of the funeral and testamentary expenses, the payment of the debts is subject to the following rules of priority—

1. Debts due to the Crown.
2. Debts having priority by Statute.
3. Debts of record, e.g. judgments and recognizances.
4. Specialty and simple contract debts.
5. Voluntary bonds.

When the estate does not suffice to pay all the debts and legacies it must be applied in the following order, which is described as "marshalling" the assets—

1. Personalty not bequeathed, or only bequeathed by way of residue.
2. A real fund, created specifically for payment of debts.
3. Real estate devised for payment of debts.
4. Real estate not specifically devised.

5. Real or personal estate devised or bequeathed subject to payment of debts.
6. General pecuniary legacies.
7. Real or personal estate specifically devised or bequeathed.
8. Real or personal estate which the Testator had power to appoint, and which he appointed by his Will.

The principal statutes relating to Executorship Law, capital and income are as follows—

Land Clauses Act, 1845.
Apportionment Act, 1870.
Settled Land Act, 1882 (repealed 1925, except Section 30).
Settled Land Act, 1890 (repealed 1925).
Trustee Act, 1893 (repealed 1925).
Finance Act, 1894.
Judicial Trustees Act, 1896. (Section 3 repealed and replaced by Trustee Act, 1925, Section 61.)
Public Trustee Act, 1906.
Law of Property Act, 1922 (repealed 1925).
Agricultural Holdings Act, 1923.
Settled Land Act, 1925.
Trustee Act, 1925.
Law of Property Act, 1925.
Administration of Estates Act, 1925.
Judicature Act, 1925.
Landlord and Tenant Act, 1927.

The Auditor should, if necessary, make a detailed report on the Trust accounts. It is well to attach to the account a schedule distinguishing between securities in respect of which income has been received during the trust year, and those in respect of which no income has been received, thus bringing the facts before the executors or trustees.

In Scotland, a special form of account, known as "Account Charge and Discharge," is raised in the case of trust estates, and appears to be more easily followed by the lay mind than the ordinary Balance Sheet.

The conflicting interests of life owner and remainderman have been a fruitful subject of litigation. There are at least 140 reported cases by which the statutes have been elucidated. Among the rules in this connexion requiring careful consideration may be mentioned the rule in *Allhusen* v. *Whittell* (1867), L.R. 4 Eq. 295; followed and developed in *Lambert* v. *Lambert* (1874), L.R. 16 Eq. 322; *McEuen* v. *Phelps*, [1913] 2 Ch. 704; and *Wills* v. *Hamilton*, [1915] 1 Ch. 769; also the rule in *Howe* v. *Lord Dartmouth* (1802), 7 Ves. 137, which is more general in its application.

One of the most important duties of an Auditor is to ascertain that proper adjustments have been made between capital and income, and to this end he must bear in mind the sections of the Apportionment Act, 1870.

It is impossible here to refer to all the cases which have been decided in the Courts, but the following may be perused with interest.

A testator who died in December, 1913, bequeathed his residuary estate to trustees upon trust to pay the dividends and income thereof to his wife for life, and after her death to stand possessed of the residuary estate in trust for his nephews and nieces. The widow died on 24th July, 1915. Part of the residuary estate consisted of stocks in three railway companies. In September, 1915, each of these railway companies declared a dividend, payable about a month afterwards, for the half-years ending on the preceding 30th June, 1915.

Held, that the Apportionment Act, 1870, applied, and the estate of the tenant for life was entitled to the whole of these dividends. "A provision in the Articles of Association of the company that a dividend shall be deemed to accrue and fall due on the day on which it is declared and not before does not exclude the Apportionment Act, 1870." In *Re Oppenheimer*, [1907] 1 Ch. 399 followed.

Stock in a public company forming part of a testator's residuary estate was settled upon trust for *A* for life, and after her death "to pay, transfer, and assign my residuary estate, and the stocks, funds, and securities upon which the same shall be invested unto and amongst" certain beneficiaries. After the death of the tenant for life the stock was sold "cum dividend" under an order of the Court for the purpose of distribution. This order was made in the absence of the legal personal representatives of the tenant for life. After the sale a dividend was declared and received by the purchaser in respect of profits, a portion of which had been earned prior to the death of the tenant for life.

Held, that the estate of the tenant for life was not entitled under the Apportionment Act, 1870, to be paid out of the purchase money of the stock anything in respect of the dividend; but, inasmuch as if the trust had been strictly carried out in accordance with the terms of the will, by transferring the investments to the beneficiaries, the representatives of the tenant for life would have been in a position, either directly or through the trustees, to obtain payment of an apportioned part of the dividend, their claim ought under the special circumstances of the case to be acceded to.—*Bulkeley* v. *Stephens*, [1896] 2 Ch. 241.

Whenever there are periodical payments accruing when the

event calling for apportionment occurs, the Act is at once brought into operation and must be applied, and when, subsequently, the accruing payments become due and payable they must be distributed in accordance with the Act as applied on the occurrence of the event which brought it into operation. Dividends declared after the life-tenant's death in respect of a period commencing and ending in his life-time belong entirely to his estate.—*Re Muirhead*; *Muirhead* v. *Hill*, [1916] 2 Ch. 181.

Shares in a company were settled upon trust to pay *A* during her life "the interest, dividends, share of profits or annual proceeds," and after her death in trust for her children. The deed of settlement of the company provided that, by the vote of the majority, out of the half-yearly profits a dividend might be declared, and a sum reserved for such contingencies as the Directors should specify. During *A's* lifetime an addition of three new fully paid-up shares to those already held in trust for her was made, pursuant to a resolution passed at a general meeting of the company to apply a portion of "the net earnings during the half-year" to necessary works, and issue new shares to represent the money so applied, a dividend being declared out of the remaining portion of the earnings.

It was held that these new shares were capital, and not income, as between tenant for life and those entitled to the remainder.—*Re Ezekiel Barton's Trust* (1868), L.R. 5 Eq. 244. This applies when a company resolves to capitalize its current profits.

The capital of a company was divided into 10,000 shares of £10 each, of which 3,728 shares only had been issued and were fully paid-up. The company was very prosperous, and the market value of its shares was £30 each. In February, 1912, the Reserve Fund of the company exceeded £50,000, and the Directors proposed a scheme for distributing part of the Reserve Fund, representing accumulated undivided profits, amongst the shareholders, so that every shareholder would get a bonus of one new fully-paid £10 share for every existing share held by him. Accordingly, resolutions were passed by the company (*a*) empowering the Directors to declare a bonus dividend out of the Reserve Fund, and (*b*) sanctioning the distribution of a bonus dividend of £10 per share out of the Reserve Fund, authorizing the further issue of 3,728 shares of £10 each out of the unissued capital of the company to be allotted *pro rata* amongst the existing shareholders, and directing that such new shares be paid up in full forthwith. The Directors then sent a circular letter to every shareholder with a warrant for the bonus dividend on his shares, informing him of an allotment to him of his proportion of the new shares and giving him an option to accept or refuse the allotment, and stating that if he accepted the allotment he was to endorse

and return the dividend warrant to the company to be applied in payment of the new shares. The trustees of a testator's will held 200 shares of the company and, on receipt of the circular letter, accepted their allotment of 200 new shares, endorsed and returned their bonus dividend warrant for £2,000 and afterwards sold the new shares at a profit. The question then arose whether, as between the tenants for life and the remaindermen under the will, the bonus dividend was capital or income.

Held, on the evidence, that the company intended to capitalize the Reserve Fund and not to distribute it as a bonus dividend, and therefore that the whole of the bonus dividend was capital of the testator's estate.—The principle of *Bouch* v. *Sproule* (1887), 12 App. Cas. 385, applied. *Re Evans*, *Jones* v. *Evans*, [1913] 1 Ch. 23.

The Directors of a company resolved to distribute accumulated profits as a bonus dividend of 50 per cent on the capital paid up, the dividend to be payable on the 6th of September, 1890. The dividend was, at the option of the shareholders, payable in cash, or applicable to the payment of the amount then due in respect of new shares or of calls. The old shares were £10 shares, some fully paid up and some £7 10s. paid up, and the distribution was made in the proportion of one new share for every two old shares fully paid up, and one new share for every eight old shares with £7 10s. paid up. A call of £2 10s. per share was to be made at the same time on such of the shares as were not fully paid up. The trustee of a will who held 150 old shares fully paid up (the tenant for life consenting, without prejudice to his rights to treat the dividend as income) accepted seventy-five new shares in lieu of the £750 bonus dividend on the 150 shares. The shares were sold for £1,363. The tenant for life claimed £750 out of the purchase money on the ground that it was income; he did not dispute that the balance was capital.

It was held that the £750 was income, on the ground that the declaration of the bonus dividend and the issue of the new shares were two distinct transactions and not one transaction, as in *Bouch* v. *Sproule* (1887), 12 App. Cas. 385, the shareholders having the option of taking the dividend in cash without taking up the new shares.—*Re Northage, Ellis* v. *Barfield* (1891), 60 L.J. Ch. 488.

In a case where a testator bequeathed his residuary personal estate to his executor in trust for the testator's wife for her life, and after her death to his executor, part of the residuary estate consisted of shares in a company whose Directors had power before recommending a dividend, to set apart out of the profits such sum as they thought proper as a Reserve Fund for meeting contingencies, etc. After the testator's death the Directors of the company distributed certain accumulated profits (which had

been temporarily capitalized) as a bonus dividend, allotted new shares (partly paid up) to each shareholder, and applied the bonus dividend in part payment of the new shares. It was held by the House of Lords that, looking at all the circumstances, the real nature of the transactions was that the company did not pay or intend to pay any sum as dividend, but intended to and did appropriate the undivided profits as an increase of the capital stock; that the bonus dividend was therefore capital of the testator's estate, and that the life tenant was not entitled to the bonus or the new shares.—*Bouch* v. *Sproule* (1887), 12 App. Cas. 405.

Note. If a company gives a *clear* option to take the profits, either as a cash dividend or in the form of new shares the cash would be income. But the terms of the offer are vital to the question.

A testator bequeathed three annuities charged upon the income and corpus of his residuary estate. The whole of his estate was settled in strict settlement upon his son and grandson. The income was insufficient to keep down the annuities, and £19 4s. 7d. was raised out of capital to satisfy the annuity of the first annuitant, who died in 1911. Sums amounting to £32 3s. 10d. had also been paid out of capital to the two surviving annuitants. It was now anticipated that there would be a surplus income in the hands of the tenant for life after satisfying the annuities. On a summons by the trustees of the will to ascertain whether this income should be applied in recouping to capital those sums raised thereout, or either of them—

Held that, having regard to the decision in *Prince* v. *Cooper* (1853), 17 Beav. 187, and to the fact that the annuities were charged upon capital as well as income, the tenant for life could not be called upon to replace the deficiency raised out of capital.—*Re Croxon, Ferrers* v. *Croxon*, [1915] 2 Ch. 290.

The Auditor in certain cases has to ascertain that the tenant for life of a testator's residuary personal estate should only receive the income of the true residue. In other words, he must be careful to ascertain that the life tenant does not receive the income of capital to which he is not entitled and which is legally required to pay the debts of the testator, legacies, and certain other payments. For this purpose he must make himself acquainted with what is known as the rule in *Allhusen* v. *Whittell* and see that it has been followed. The rule is to the following effect. It must first be ascertained what is the amount of capital of the testator at the date of his death plus the gross income, including income accrued, of the first year succeeding the testator's death. This will practically form the total fund which, when ascertained, is available for the payment of debts, legacies, and other deductions. Secondly, there must be ascertained the amount that may

be required to pay such deductions (which do not form any part of what may be described as the true residue to which the tenant for life is only entitled). The proportion of the income of the first year attributable to the secondly ascertained amount will be according to the ratio the sum required to pay debts, legacies, etc., bears to the total fund available for the payment thereof. In other words, the life tenant of residual personal estate is not entitled to any income from the portion of the estate which is required for the payment of the testator's debts, funeral, testamentary expenses, and immediate legacies.

The following cases bear on this rule—

The Rule laid down in *Allhusen* v. *Whittell* (1867), L.R. 4 Eq. 295, was that in adjusting the accounts between the tenant for life of the residuary estate of a testator and the remaindermen the executors must be taken to have paid the debts and legacies not out of capital only or out of income only, but with such portion of the capital as, together with the income of that portion for one year from the testator's death, was sufficient for the purpose. Although it worked perfectly in that case and works equally well in any case where the capital subtracted from the gross estate before the ascertainment of residue is not subtracted before the end of the first year from the testator's death, it is not to be slavishly followed in every administration where residue is settled, and is inapplicable in hard and fast terms to a case where the subtractions from the estate occur at periods substantially anterior to the close of the first year.

A testator died on 6th February, 1911, having by his will given legacies to be paid free oi all duty, and given his residuary estate as to each of four-fifths thereof in trust for one of certain persons for life, with remainder to his or her children. The executors paid the estate duty, legacy duty, legacies and debts at various dates during the year immediately succeeding the testator's death, for instance, over £47,000 for estate duty on 1st April, 1911, legacy duty of £1,370 on 1st July, 1911, legacies of about £14,000 in June and July, and debts and funeral expenses amounting to nearly £600 in May, 1911.

Held, (1) that the equitable book-keeping or mode of adjustment to be adopted, on taking the account of the share of income during the year succeeding the testator's death due to the tenants for life, was that there should be charged against them, in respect of the payment for estate duty, debts, funeral and testamentary expenses, and duty on legacies given free of duty, interest upon the capital sum which would, with such interest, make up the sums paid in respect of estate duty, etc., such interest being calculated only during the respective periods from the death of the testator until the respective times when the sums paid for estate

duty, etc., were in fact paid; and (2) that the method of adjustment adopted in this particular case was not the only method available, and that extremely elaborate and minute calculations need not be gone through, in every case.—*Re McEuen, McEuen* v. *Phelps*, [1913] 2 Ch. 704. The rate of interest to be used should be agreed between all the interested parties and income tax should be taken into consideration in fixing the rate.

A testator, by his will, gave his real and personal estate not thereby otherwise disposed of, therein called his residuary estate, to his trustees in trust to sell, and out of the proceeds pay or provide for debts, funeral and testamentary expenses, legacies and annuities, and duties, and to divide the residue into nine equal shares, and to invest and pay the income of one-ninth share to each of his three daughters during her life with remainders over, and (by Clause 15) the testator empowered his trustees to postpone the sale and conversion of all or any part of his real and personal estate as long as they should think proper, and directed that the income from his estate however invested should, after his death, be treated as income, and no part thereof should be added to capital. Testator died in 1909 leaving an estate of great value. The payments required to be made out of his residuary estate in respect of debts, legacies, duties, etc., were not concluded till the expiration of five years from the date of the testators' death. The average rate of interest earned by the estate in each of these five years varied considerably. On an originating summons raising the question how the accounts ought to be adjusted between the tenants for life and the remaindermen of the daughters' settled shares of residue.

Held, that the direction contained in Clause 15 of the will did not displace the rule in *Allhusen* v. *Whittell* (1867), L.R. 4 Eq., 295, and *Re McEuen*, [1913] 2 Ch. 704.

Held, also, that the true principle was to deprive the tenant for life of the income of such a sum as together with interest thereon from the date of the testator's death down to the date of payment, was sufficient to satisfy the liabilities.

Held, also, that the principle was not limited to the payments made during the first year from the testator's death, but applied equally to payments made during the subsequent years.

Held, also, that the average rate of interest earned by the estate in each year ought to be adopted for the purpose of this calculation.

Held, also, that as regards estate duty the total amount paid for duty and interest thereon ought to be treated as the debt or liability to be paid or discharged.—*In re Wills, Wills* v. *Hamilton*, [1915] 1 Ch. 769.

Note. A well advised testator will exclude the Rule in _Allhusen v. Whittell_ from his will for it is difficult and costly to apply.

By his will a testator empowered his trustees to invest any part of the trust estate in "the debentures or debenture stock, or preference stock of any railway or other company in the United Kingdom."

Held, that inasmuch as there was a distinction, although a minute one, between the two classes of investments described as preference stock and preference shares, it was not within the power of the trustees to invest any part of the trust estate in the fully-paid preference shares of any joint stock company.—*Spencer* v. *Wills*, [1911] 2 Ch. 563.

The life tenant of the residue is not, in the absence of any special provision in the will, entitled to the income produced by unauthorized investments. The rule is that such investments must be sold and the proceeds invested in consols or other authorized investments of a permanent character.—*Howe* v. *Lord Dartmouth* (1802), 7 Ves. 137. By the Law of Property Act, 1925, Section 28, subsection 2, leaseholds held upon trust for sale have been taken out of the rule as from 1st January, 1926, unless there is a direction in the will to the contrary (*Re Brooker*, [1926] W.N. 93), and it seems that this rule does not now apply to any leaseholds.

The Rule does not apply to real estates.

The expression "testamentary expenses" in a will includes the estate duty in respect of the personal property of which the testator or other person whose "testamentary expenses" are referred to was competent to dispose at his death.

A direction for the payment of "testamentary expenses" may extend to the expenses of administration under the intestacy of some other person.

A testator by his will gave his residuary estate to trustees upon trust to convert and to invest the net proceeds and pay the income to his wife during her life; and after her decease he directed his trustees, after paying his widow's funeral and "testamentary expenses" and debts, to apply his residuary estate as therein mentioned. The testator's wife survived him, and signed a document which purported to be her will. After her death the plaintiff and her brother, who were in the same relationship to the widow and were her next-of-kin, disputed the will, and the brother brought an action in the Probate Division to have a grant of administration to the estate of the widow made to him. The Court pronounced against the alleged will, but made no order as to costs. Letters of administration to the widow's estate were subsequently granted to the plaintiff with the assent of her brother.

Held, that the direction for payment of the "testamentary expenses" of the testator's widow extended to (1) the costs and expenses of the plaintiff in obtaining the letters of administration,

and in connexion with the administration of the estate of the widow; (2) the costs of the brother of the action in the Probate Division; and (3) the estate duty payable on the death of the widow in respect of her personal property.—*Re Clemow, Yeo* v. *Clemow*, [1900], 2 Ch. 182.

Where a testator empowers the trustees of his will to invest moneys in (amongst other things) the "stocks, funds and securities (not payable to bearer) of any corporation or company, municipal, commercial or otherwise," the clause does not confine the trustees to the stocks, funds and securities of corporations and companies formed or registered in the United Kingdom.—*Re Stanley, Tennant* v. *Stanley*, [1906] 1 Ch. 131.

The plaintiff's costs of an unsuccessful action impeaching the validity of a will, though ordered by the Judge of the Probate Division to be paid out of the testator's estate, are not testamentary expenses.—*Re Prince, Godwin* v. *Prince*, [1898] 2 Ch. 225.

Settlement estate duty on personalty is not a testamentary expense, although the executor is accountable for it. It is, therefore, payable out of the settled property under the Finance Act, 1896, Section 19, Subsection (1), notwithstanding a direction in the will to pay testamentary expenses out of residue.—*Re King, Travers* v. *Kelly*, [1904] 1 Ch. 363.

Estate duty payable in respect of real estate is not a "testamentary expense" within the meaning of a direction contained in the will of a testator who died after the Land Transfer Act, 1897, for payment of his debts, funeral and testamentary expenses, out of his personal estate.—*Re Sharman, Wright* v. *Sharman*, [1901] 2 Ch. 280.

A testatrix having directed the executors and trustees of her will to pay her testamentary expenses, bequeathed (*inter alia*) certain specific personalty, over which she had a general power of appointment, to her trustees upon trust for certain specific legatees. She devised and bequeathed her residuary real and personal estate to her trustees upon trust for sale and conversion, the net proceeds to be paid to certain residuary legatees.

It was held by Swinfen Eady, J., that the appointed fund had passed to the executors "as such" within the meaning of the Finance Act, 1894, Section 9, Subsection (1), so that the estate duty was payable out of residue. *Held, also*, that the will itself imposed this duty on the residue, the residuary estate being what remained after satisfying the previous dispositions of the will, including the direction to pay testamentary expenses, which covered estate duty.—*Re Fearnsides, Baines* v. *Chadwick*, [1903] 1 Ch. 250.

A testatrix by will settled certain real property upon several

persons in succession, and directed her trustees to stand possessed of her residuary personal estate upon trust to pay (amongst other things) the estate duty on the whole of the real and personal estate devised and bequeathed by her will. It was held that "estate duty" included "settlement estate duty."—*Re Leveridge, Spain* v. *Lejoindre*, [1901] 2 Ch. 830.

A testatrix, after giving a specific legacy on trust by way of settlement, directed that her debts, funeral and testamentary expenses, "including all duties payable by law" out of her estate, and including the duties on certain annuities given by her will, and on all legacies bequeathed by her duty free, should be paid out of funds which she designated. She then directed certain legacies to be paid out of these funds free of duty. It was held that the special direction in the will for payment of duties payable by law out of the testatrix's estate referred to duties which by law were payable out of the general residuary estate of the testatrix, and not to duties which by law were made payable out of specific property, and that therefore the direction did not amount to such an express provision as was required by Section 19 of the Finance Act 1896, in order to make the settlement estate duty payable, otherwise than out of the settled legacy. *Held* accordingly, that the settlement estate duty payable in respect of the settled legacy must be paid thereout.—*Re Lewis, Lewis* v. *Smith*, [1900] 2 Ch. 176.

Where a general power of appointment over a fund is exercised by will, the appointed fund does not pass to the executor as such; consequently, the estate duty in respect thereof (in the absence of any direction in the will to the contrary) is payable out of the fund; but such estate duty falls within the description of testamentary expenses; consequently, where the will contains a direction to pay testamentary expenses out of the residue, the estate duty in respect of the fund is payable out of the residue.—*Re Treasure, Wild* v. *Stanham*, [1900] 2 Ch. 648.

This decision of Kekewich, J., was not followed by Buckley, J., *Re Moore, Moore* v. *Moore*, [1901] 1 Ch. 696, but was followed by Byrne, J., *Re Power, Re Stone, Acworth* v. *Stone*, [1901] 2 Ch. 659. It was referred to by Kekewich, J., in *Re Sharman, Wright* v. *Sharman*, [1901] 2 Ch. 280, and followed by him in *Re Maddock, Llewelyn* v. *Washington*, [1901] 2 Ch. 372.

When pecuniary legacies or shares of the residue of a testator's personal estate are settled by his will, no part of either the estate duty or the settlement estate duty imposed by the Finance Act, 1894, is to be borne by the settled legacies or shares, but the whole of those duties must be borne by the general residue.—*Re Webber, Gribble* v. *Webber*, [1896] 1 Ch. 914.

Simple contract debts cannot be paid in preference to specialty

debts in the case of an insolvent estate.—*Re Hankey, Cunliffe Smith* v. *Hankey*, [1899] 1 Ch. 541.

The commission charged by an estate agent for procuring a building lease of settled land for a tenant for life under the Settled Land Act, 1882, is payable out of capital money arising under the Act.—*Re Maryon-Wilson's Settled Estates*, [1901] 1 Ch. 934. But not his charges for letting for a short term.—*Re Leveson-Gower*, [1905] 2 Ch. 95.

The income fee payable to the Public Trustee in respect of life annuities bequeathed by a will is payable out of those annuities and not out of residue.—*Re Bentley, Public Trustee* v. *Bentley*, [1914] 2 Ch. 456.

A bequest of "moneys owing to me at the time of my decease" has been held to include moneys on deposit at a testator's bank, whether notice of withdrawal is or is not required in respect of the same.—*Re Derbyshire, Webb* v. *Derbyshire*, [1906] 1 Ch. 135.

A bequest of "moneys at the bank" did not include an unused letter of credit held by the testator, according to an opinion given by counsel.

A testatrix specifically bequeathed all the "stocks, shares, debentures, debenture stock, and all other securities which shall be standing in my name at my decease." At her decease the testatrix was possessed of foreign Government Bonds to bearer, which, together with certain stock certificates, were kept by her bankers in an envelope, marked outside with her name and also with a reference to the page of a safe custody register kept by the bankers on which the securities were entered under the heading of her name—

Held, that the bonds to bearer were not included in the specific bequest.—*Re Mayne, Stoneham* v. *Woods*, [1914] 2 Ch. 115.

Interest on advances made by the trustees under a will which has to be brought into hotchpot must be calculated at the rate of 4 per cent per annum.—*Re Davy, Hollingsworth* v. *Davy*, [1908] 1 Ch. 61.

When a testator empowers the trustees of his will to invest in the stocks, funds, and securities of "any corporation or company, municipal, commercial, or otherwise," the words "corporation or company" mean an incorporated body or unincorporated body which is "municipal, commercial or otherwise," and which is of such a kind as not to be what is commonly called "a firm." The word "company" has no strictly technical meaning. It involves two ideas, namely: first, that the association is of persons so numerous as not to be aptly described as a firm; and, secondly, that the consent of all the other members is not required to the transfer of a member's interest.—*Re Stanley, Tennant* v. *Stanley*, [1906] 1 Ch. 131.

When trustees hold shares of a company belonging to the trust, and they are appointed Directors of the company in respect of such holding, and there is no provision in the will enabling them to retain their remuneration as such Directors for their own benefit, they must account for such remuneration to the trust, and the remuneration is to be treated as capital, and will go to the remaindermen as an accretion to their shares.—*Re Francis* (1905), 92 L.T. 77; but the decision in *Re Dover Coalfield*, [1908] 1 Ch. 65 suggests that the fees do not belong to the trust.

A testator directed payment out of the income of his estate of £200 per annum "free of all duties" to a solicitor-trustee for his trouble in acting as a trustee of his will, so long as he should continue to act as such trustee, and also in addition gave him power to charge and be paid for professional and other charges.

Held, affirming the decision of Neville, J., that the sum of £200 was to be paid subject to and not free of income tax.—*Re Saillard, Pratt* v. *Gamble*, [1917] 2 Ch. 401.

On the death of a testator carrying on a business, accounts would normally be made up to the date of death. On the death of a partner in a firm the capital of the deceased would be ascertained in a similar manner or in accordance with the provisions of the partnership deed, and in both cases no difficulty should arise in apportioning the receipts between capital and income.

On the death of a life tenant entitled to the profits of a business or a share thereof, however, as between his estate and the subsequent life tenant or the remainderman, the Apportionment Act, 1870, does not apply and the profits belong to the person entitled to the income at the end of the period for which the profits are declared.—*Browne* v. *Collins* (1871), L.R. 12 Eq. 586. For example, if a life tenant dies in February and on 1st May following the trustees receive an amount on account of the profits of the business in respect of the year ended 31st December preceding, such sum would belong to the life tenant's estate, but if in respect of the year ended 31st March, to the subsequent life tenant or to the remainderman.

A partner, on retiring from his firm, left his capital in the business under an agreement with the continuing partners that it should be a debt due from them to him, and bearing interest until repayment. The agreement contained a stipulation that the outgoing partner should have free access to the books at all times, and various provisions intended to satisfy the outgoing partner from time to time of the solvency of the business; upon breach of any one of these provisions he was to be at liberty to call in his capital. The outgoing partner subsequently died, having by his will bequeathed his residuary estate, which included his capital

in the business, to a trustee, upon trusts for one for life and for others in remainder.

It was held by the Court of Appeal that the trustee was at liberty to employ professional accountants and valuers for an audit and stocktaking once a year, if desired, or oftener if special circumstances so required, and that the expenses of these audits were costs, charges, and expenses incurred by the trustee in the execution of the trusts of the will for the benefit of the whole estate, and were therefore payable out of capital, and not out of income.—*Re Bennett, Jones* v. *Bennett,* [1896] 1 Ch. 778.

Note. In an unreported case the Court directed that the Auditor's fees should be charged to capital. See also Section 22 (4) of the Trustee Act, 1925, referred to earlier in this chapter, regarding the apportionment of Auditors' charges.

A bequest of shares in a limited company, coupled with a declaration that the shares so bequeathed shall carry the dividend accruing thereon at the testator's death, operates as an exclusion of the Apportionment Act.

A testator bequeathed certain shares in a limited company to trustees upon trust to sell, with a power of postponement, and stand possessed of the proceeds and the shares remaining unsold upon trust to receive the annual produce thereof and hold the same in trust for the testator's children and remoter issue in succession, and declared that every share bequeathed by his will should carry the dividend accruing thereon at his death. The dividends were payable annually. It was held by the Court of Appeal that the trustees should take the whole of the dividend for the year in which the testator died without apportionment, and that such dividend was payable as income to the tenants for life under the will.—*Re Lysaght, Lysaght* v. *Lysaght,* [1898] 1 Ch. 115.

A testator directed that the whole of the income of stocks, out of which his wife was entitled to an annuity, should be paid to her during widowhood. It was held that he had expressly stipulated, within the meaning of Section 7 of the Apportionment Act, 1870, that that Act should not apply.—*Re Meredith, Stone* v. *Meredith,* [1898] W.N. 48.

The Apportionment Act, 1870, is not excluded by a power to postpone a trust for sale coupled with a direction that pending sale "the whole of the income of property actually producing income" shall be applied as from the testator's death as income.—*Re Edwards, Newbury* v. *Edwards,* [1918] 1 Ch. 142.

The word "dividends" in the Apportionment Act of 1870, Section 2, includes payments by way of bonus or surplus profits to the shareholders of a public company, even though such payments may be only occasional and not strictly periodical, but

"dividend" does not include payments by way of a return of capital.—*Re Griffith, Carr* v. *Griffith* (1871), L.R. 12 Eq. 655.

Executors and trustees are bound to keep accounts, and to give a satisfactory statement of the state of a testator's assets.—*Ottley* v. *Gilby* (1846), 8 Beav. 692.

In a case where proceedings for administration are rendered necessary by the gross and indefensible neglect of trustees to deliver accounts, the defaulting trustees may be ordered to pay all the costs, including the costs of taking and vouching the accounts. Such an order may be made in proceedings commenced by originating summons.—*Re Skinner, Cooper* v. *Skinner*, [1904] 1 Ch. 289.

The Court will not as a rule control a trustee's discretion as to investments.—*Lee* v. *Young* (1843), 2 Y. & C.Ch.Cas. 532. The Trustee Act, 1925, lays down what are authorized trustee securities and contains important provisions as to the power of trustees and the care to be exercised by them.

When a testator gives power to his trustees to appoint a factor to the estate, who may be one of themselves, but at the same time guards that provision with this further one: that the other trustees shall at least once in every year, within one month from the termination of the year, examine and audit the whole of the last year's accounts, require vouchers, and see that the accounts had been properly kept, and that the money had been properly received and properly applied, the trustees are guilty of *culpa lata* if they fail to call for annual accounts.—*Carruthers* v. *Carruthers*, [1896] A.C. 659.

A trustee, who was himself one of the beneficiaries, had inadvertently overpaid the other beneficiaries their share of income, and died before any adjustment had been made. It was held that the executors of the deceased trustee were not entitled to recover from the other beneficiaries the amounts so overpaid, or to have accrued, or future income impounded till the shares were equalized, by reason of the fact that their testator himself was the person responsible for the mistake that had been made.—*Re Horne, Wilson* v. *Cox Sinclair*, [1905] 1 Ch. 76.

It is a breach ot trust for trustees, having the ordinary power to invest on "real securities," to invest on a contributory mortgage in the absence of an express authority.—*Webb* v. *James* (1888), 39 Ch.D. 660.

Trustees are not justified in advancing trust moneys on a second mortgage (*Drosier* v. *Nelson*, [1876] W.N. 225) or on mortgages of leaseholds (*Re Chennell* (1877), 8 Ch.D. 492).

Trustees who lend a larger sum than is authorized on security of property will not be chargeable with breach of trust if in making the loan they acted on a report of a person whom they believed to

be a competent valuer (Section 8 of the Trustee Act, 1925), but the valuer should be employed by the trustees themselves.—*Conn* v. *Wilson* (1888), 39 Ch.D. 39.

This Section, which replaces and extends Section 5 of the Trustee Act, 1888, will not, however, help trustees who take hazardous securities.—*Blyth* v. *Fladgate*, [1891] 1 Ch. 337.

Re Crabtree, Thomas v. *Crabtree* (1912), 106 L.T. 49

Under the will of the testator, the trustees were given power to carry on his business during the lifetime of his wife, the profits arising from the business to be paid to her.

In arriving at the profits, depreciation at the rate of 7½ per cent was written off machinery on its original cost, as well as repairs. The life tenant objected and brought an action to have the depreciation disallowed. The Court of Appeal decided that the depreciation was a proper charge.

Cozens Hardy, M.R., said—

In the ordinary course of ascertaining the profits of a business where there is power machinery and trade machinery, which is necessary in order to perform the work of the business, it is, in my opinion, essential that, in addition to all sums actually expended in repairing the machinery, or in renewing parts, there should be also written off a proper sum for depreciation, and that sum ought to be written off before you can arrive at the net profits of the business, or at the profits of the business, and it is not profit until a proper sum, varying with the class of machinery, with the nature of the business, and the life of the machinery, has been written off for depreciation.

CHAPTER XVI

PARTNERSHIPS

As far as partnership accounts are concerned, a complete audit is sometimes required by the active partners themselves, though more often by a sleeping partner, a retired partner whose interests have not been liquidated, or it may be by trustees or others interested in the partnership business. More frequently, however, a professional Accountant is employed simply to raise a true and correct Balance Sheet as between all parties, an arrangement which is often loosely referred to as an audit. The Accountant should take care that there is no misunderstanding as to the actual duties he has undertaken. It is desirable in every case to have a clear arrangement reduced to writing, otherwise the "glorious uncertainty of the law" may fix the Accountant with a responsibility which he at least had never contemplated, and for which he had received no *quid pro quo*. For example, in an action for damages for negligence, it has been held that an Accountant employed to check books and prepare a Balance Sheet should agree the Cash Book with the Bank Pass-book, or inform his client he has not done so, though, as every Auditor knows, a Bank Pass-book is not conclusive evidence without the banker's certificate as to the balance, since the Bank Book itself is capable of being manipulated. Many private limited companies, which are the conversion of partnerships into companies in which the partners become the sole directors and shareholders, retain all the business characteristics of a partnership, and on the ground of expense the director-shareholders frequently desire only a partial audit. In such cases the auditor will do well to safeguard himself by suitably qualifying his certificate.

A summary should be made of the conditions laid down in the partnership deed as to partners' salaries, Capital Accounts, Drawings Accounts, Loan Accounts, interest on capital and loans, interest on drawings, and any other material points, particularly those of a financial character.

If there be any points as to accounting in the agreement which are obscure, they should be cleared up by means of a supplementary agreement. A common practice is, at the end of the partnership year, to credit the Capital Account of each partner with the amount of his share of the profits and interest on his capital, less his drawings and interest thereon, and to carry forward the resulting balances as capital. As a result, each partner's capital may vary from year to year. This practice should not be followed

unless it is in accordance with the partnership deed. It may be that any surplus over the amount of capital for which the deed stipulates should be treated as a loan to the partnership, ranking as between the partners before the stipulated amount of capital and carrying interest at a different rate, or there may be no provision at all to meet the case. Where a Partner's Capital Account shows a deficiency, it is also a common practice to charge interest on the amount of the deficiency, regardless of the fact that this charge may not be stipulated in the partnership deed. Any departure such as this from the terms of the deed should be brought to the notice of each partner. The Auditor should see that any borrowings of the firm's money by a partner, or any moneys due by a partner to the firm for goods supplied by the firm to him are not included among Sundry Debtors, but clearly set out in the accounts. He should also see that all the partners sign the accounts as correct.

It is not unusual for income tax paid by the firm to be charged to profits as if it were an expense. Unless, however, the partners' interest on capital, share of profits, and salaries are in strict ratio and they have no claim to relief, this method of charging income tax is not correct. Tax should be treated as a drawing, and charged to the partners' individual accounts according to their individual liability, which is based upon the partner's salary, interest on capital less interest on drawings, and his share of the profits after deducting these items and taking into account any claims for relief.

Interest on drawings should be chaıged where the drawings are unequal as to date and amount. Each partner should be asked to agree the amount of his drawings. Where partners are lax as to control of drawings, a dishonest cashier has been known to appropriate money and enter it as partners' drawings, and—an extreme case—the drawings of a deceased partner have been known to continue (according to the books) for some time after his demise. If there are any agreements with third parties restricting drawings, see that the agreements are complied with.

Clauses in the partnership agreement as to computing goodwill in the event of a partner dying or retiring are not always clear, especially as to what is to be considered to be a net profit. The Auditor should study these clauses carefully, and, if necessary, have them amended. If any third party has a right to share in the profits, the Auditor should see that the method in which the share is to be calculated is clearly set out in the agreement relating thereto, and that the correct amount is duly charged in the Profit and Loss Account.

Care should be taken to see that any loans either to or by the partnership have been approved by the whole of the partners, and

any borrowing or lending contrary to the Partnership Articles should be reported to them, especially any loans made to any individual partner.

In the case of an incoming or outgoing partner the apportionment of the receipts and expenses should be verified and care taken that the assets and liabilities are correctly adjusted as between the parties.

In the case of a shipping partnership, where an exceptional partnership agreement provided that partners should share profits equally but that loss of capital should be borne as to two-thirds by the senior partner and one-third by the junior partner, a ship which had not been adequately insured was lost at sea. The loss was ruled by an arbitrator to be a loss of capital. The neglect to insure adequately was admitted to be attributable to the senior partner, otherwise a nice question as to partnership liabilities *inter se* would have arisen.

The Auditor should be familiar with the Partnership Act of 1890, and the Limited Partnerships Acts, 1907. Partnerships under the Limited Partnerships Act must be registered as such in accordance with the provisions of the Act, and must consist of one or more persons called general partners and one or more persons called limited partners. The limited partners, besides having the benefit of limited liability, have also limited functions and rights. An Auditor appointed by a limited partner, under Section 6 of the Act, to inspect the books, should satisfy himself as to his duties and rights.

Registration under the Limited Partnerships Act is very rare having regard to opportunities of securing similar benefits by registration of a private company under the Companies Act. It is not proposed therefore to consider the provisions in detail in this volume.

The Auditor will find a *Digest of the Law of Partnership and an Appendix on the Limited Partnerships Act*, 1907 (Pollock) a valuable work of reference.

CASES

In a case decided by the House of Lords, taken on appeal from a judgment by the First Division of the Court of Session, Scotland, the appellant had advanced £15,000 to the respondent, to be used in the business of the respondent for five years. In return for the advance, the appellant was to receive interest and 37½ per cent of the profits of the respondent's business. The contract stipulated that there should be an annual audit of the respondent's business by a firm of Chartered Accountants, and that their certificate as to the profits should be binding on both parties. For four years the respondent's books were audited by a member of the firm

of Chartered Accountants. Subsequently the appellant raised this action against the respondent for a Judicial Account, on the ground that the audits had not been in terms of the agreement, in respect that the Auditor did not know that his estimate of the profits was to be binding on the appellant and respondent. The Auditor swore in his evidence that he did not know of this Agreement, and that, if he had, he would have made out the account in a somewhat different form. The House of Lords held that there must be a new account taken, the Auditor being unaware that his audit was to be final between the parties.—*Teacher* v. *Calder*, [1899] A.C. 451.

In the absence of any agreement to the contrary partners are liable to share losses equally.—*Saffery* v. *Mayer*, [1901] 1 K.B. 11.

Every partner has a right to have accurate accounts kept and to have free access to them.—*Rowe* v. *Wood* (1822), 2 Jac. & W. 558; *Goodman* v. *Whitcomb* (1814), 3 V. & B. 36.

A partner cannot insist on the production of documents to an improper person.—*Dadswell* v. *Jacobs* (1887), 34 Ch.D. 278.

In ascertaining the "profits" of a partnership (solicitors) in the absence of special agreement to the contrary, the net profits of each year must be ascertained on the footing of the moneys actually received and paid in that year without reference to when the work is done in respect of which the moneys are received.—*Badham* v. *Williams* (1902), 86 L.T. 191.

G, M, and W went into partnership under a parol agreement that the capital of the business should be contributed by them in certain unequal shares, but that profits should be divided equally. Upon a dissolution, after satisfying all liabilities to creditors, and the advances of two of the partners, the assets were insufficient to make good the capital. A considerably larger sum was due in respect of capital to G than to M.

Held that the true principle of division of assets was for each partner to be treated as liable to contribute an equal third share of the deficiency, and then to apply the assets in paying to each partner rateably what was due to him in respect of capital.—*Garner* v. *Murray*, [1904] 1 Ch. 57.

Every partner is entitled by the Partnership Act, 1890, Section 24 (9), to have access to and to inspect and copy the books of the partnership, and is entitled to have the books and accounts examined on his behalf by a Chartered Accountant or by an agent appointed by him for the purpose, provided that the agent is a person to whom no reasonable objection can be taken by the other partners, the agent undertaking not to make use of the information which he should thus acquire, except for the purpose of confidentially advising his principal.—*Bevan* v. *Webb*, [1901] 2 Ch. 59.

CHAPTER XVII

VARIOUS CLASSES OF AUDITS

Particulars in this chapter should be read in relation to the routine set out in previous chapters.

AIRCRAFT COMPANIES

The detail of the work is the same as in the case of any manufacturing concern.

Special items in the Balance Sheet are various installations and specialized machines and tools, regarding which questions of depreciation and obsolescence require careful consideration.

There may also be rights of various kinds of which the value may not be permanent. From the nature of the case, there is not likely to be any accumulation of finished aircraft; if there is, the method of valuation will be a matter for inquiry.

BANKS

The great joint stock banks are so well organized as to be able to publish their accounts duly audited within about ten days from the close of the year. A continuous internal supervision is exercised over the transactions from day to day. The Auditor may, therefore, accept the vast mass of detail as correct (it would be impracticable to do otherwise), and devote himself to a close consideration of the Balance Sheet, involving a scrutiny of the various Ledger Accounts and balances, and the verification of the assets. He should satisfy himself to the best of his judgment that the loans made are adequately covered, that all known liabilities are brought into account, the assets correctly valued, and losses provided for. The principal work to be done is as follows.

Cash. Attend a little before or immediately after the close of business on the last day of the year. Have the cash brought out of the tills and safes, and count or weigh it. For convenience in counting, notes should be arranged according to their amounts. A memorandum should be made of the respective amounts of notes, silver and copper produced. The current cash should be agreed with the Effects Book, also with the Day Book, adding, if necessary, the cheques payable at other banks not collected, which may or may not be treated as cash. See that the Day Book is balanced, and the figures inked in and carried forward to the next day. Trace also cheques which the bank has not been able to present for payment (if they are not included in the cash). Procure certificates for cash at the Bank of England and other

banks. Officials of the bank should be present during the counting of the cash and securities, and take charge of them at the close of the inspection.

Securities Deposited Against Loans, Overdrafts, and Acceptances. See a sufficient number of the securities as in the Customers Securities Book. Examine Loan Accounts in Loan Ledger, and see whether the margin of cover appears adequate, having regard to the value of the security. In case of loans against produce, see valuation by a broker. Look at date of warrants, and see that produce is not old and possibly unsaleable. Note the general tenor of the account, and whether shipments cleared off satisfactorily or not. Note whether there is any contingent liability for uncalled capital in respect of any of the securities in the name of the bank or the bank's nominees. See that interest is not being charged in respect of accounts which appear to be doubtful. Note any exceptionally large loans and scrutinize closely.

Bank's Investments. See the securities for the bank's investments as in the Investment Ledger and check the valuation, and ascertain whether adequately depreciated. Note whether any are hypothecated for any special purpose requiring disclosure in Balance Sheet.

Investments held for Safe Custody and Collection of Dividends. See a sufficient number of the securities as in the register, and trace payment of a certain number of the dividends.

Bills Discounted. Examine bills with list of bills on hand. See that bills are not overdue. Agree with the Bills Account. See whether any exceptionally large amounts relate to individual firms, and make inquiries. See that a rebate is made in respect of discount on bills not matured, as the practice is to carry the whole of the discount to the credit of Interest and Discount Account when bills are discounted. Note at what rate the rebate is calculated, and whether it is a fixed rate, or the rate at which the bills were discounted, or the rate at which they could be rediscounted. See that the same principle is followed from year to year.

Deposits and Current Accounts. The list of balances on Deposit and Current Account should be examined with the Ledgers. Any overdrawn Current Accounts should be satisfactorily explained. The overdrawn amounts should not be deducted from the total liabilities on Current Account. See that Interest on Deposit Accounts is duly provided for up to date. A number of Pass-books, if Pass-books are used, may also be compared with the Ledger Accounts.

General Ledger. The Balance Sheet should be compared with the General Ledger balances, and the General Ledger balances agreed with the respective totals of the balances of the subsidiary Ledgers.

Branches. Examine the Branch Accounts and see that they are satisfactorily incorporated in the Head Office Accounts. The Companies Act, 1929, Section 134, provides that

In the case of a banking company registered after the fifteenth day of August, eighteen hundred and seventy-nine, if the company has branch banks beyond the limits of Europe, it shall be sufficient if the Auditor is allowed access to such copies of and extracts from the books and accounts of any such branch as have been transmitted to the head office of the company in Great Britain.

Section 131, dealing with periodical publication, should be studied.

Balance Sheet. The practice varies, but in a well drawn Balance Sheet a distinction is made between (1) Coin and Bank Notes, and Balances with the Bank of England and other banks, (2) Money at Call and Short Notice, (3) Bills Discounted, (4) Short Loans, and (5) Loans of a permanent character (if any), such as mortgages. Investments should be classified, and the liability on Deposit and Current Accounts distinguished from other liabilities.

Form of Certificate. In some cases auditors give the common form of certificate as follows—

We report that we have examined the above Balance Sheet with the books of the bank, and have obtained all the information and explanations we have required, and we are of opinion that such Balance Sheet is properly drawn up so as to exhibit a true and correct view of the state of the bank's affairs according to the best of our information, and the explanations given to us and as shown by the books.

The following is a more amplified form—

We have examined the above Balance Sheet in detail with the books at head office and with the certified returns from the branches. We have satisfied ourselves as to the correctness of the coin, bank-notes and balances with the Bank of England, cheques in course of collection on other banks in the United Kingdom, and bills discounted, and have verified the correctness of the money at call and short notice. We have also verified the securities representing the investments of the bank, and having obtained all the information and explanations we have required, we are of opinion that such Balance Sheet is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs according to the best of our information and the explanations given to us and as shown by the books of the company.

The amount of liabilities on account of acceptances and engagements on account of customers (on which there is a contingent liability) is usually stated on both sides of the Balance Sheet, or is sometimes mentioned in a foot-note.

It is a common practice to write down or even write off bank premises, investments, etc., the amounts so written off being mentioned in the annual report, and thereafter becoming "hidden reserves," commonly called "Internal Reserves." As values may fluctuate widely over a term of years, the conservative practice

adopted by the great banks is essentially sound from a financial point of view, and adds to the "liquidity" of the Balance Sheet.

The system of internal control to-day is usually so effective that much of the work considered necessary in the past may safely be dispensed with. More particularly is this the case since the introduction of mechanical systems of record.

BREWERIES

The accounts of many breweries are masterpieces of accountancy. The Brewing Account sets out the total quantities of hops, malt, and other brewing ingredients used (which are agreed with the quantities purchased after allowing for stocks), also the wages, expenses, and other costs of brewing on the debit side, thus establishing the total cost of the beer brewed and racked, and the cost per barrel. Any wastage in the process of brewing is also brought out. The Beer Account, which is charged with the cost of the beer racked, as shown by the Brewing Account sets out in classified totals the number of barrels sold, the total money, the average selling price per barrel of each class of beer, and the average profit per barrel. The barrels sold, after allowing for beer bottled, is agreed with the total production. The business done, in barrels and money, with each tied house is also shown, set out in schedules, together with the rent receivable, rent payable, and loans (if any) to the publican, also the amount owing in respect of rent and for beer, wines, and spirits.

To enable accounts to be raised in this way the books are kept on the columnar system, and in considerable detail. The Auditor has no difficulty in testing the accuracy of the accounts and schedules by reference to the books and vouchers. The beer brewed, quantities of ingredients used, cost, etc., may be compared with the Brewers' Book, and a certificate may be obtained from the Excise Officer as to the gross number of barrels brewed from which racking losses and losses in cellar should be deducted. In examining the book debts, note how much is due on account of beer, wines and spirits, and rent, also the length of the lease or agreement under which the house is held, also keep an eye on discounts, which are exceptionally heavy and variable. Note how casks, cases, etc., are charged out to customers, and see that they are not included both as book debts and stock.

Where there are managed houses, see that there is a sufficient check on the accounts submitted. The stocks of these houses are usually taken at selling price, and in bringing them into the annual accounts the usual discounts must therefore be deducted. See that payments on account of Compensation Fund are all charged to income. Where licences are cancelled, any amount received in excess of the book value of the house should be regarded as a

reserve. Should there be a deficiency, the deficiency might, technically speaking, be looked upon as a loss of capital, but it is sounder to write the deficiency off to Profit and Loss Account, or against reserve, and that is usually done.

See that sufficient depreciation is written off casks, jars and cases charged to customers (and returnable), as well as off those in hand. See that only actual improvements are capitalized, and that repairs are all charged to profits. See that sufficient provision is made for depreciation of leaseholds. If any houses be sold at a profit, the profit should be carried to a reserve, out of which any losses should be written off. Failing such a reserve, losses should be written off against profits.

Inquire as to forward contracts for hops, etc. If markets have fallen sufficient reserves should be made. See that sales of grains are duly accounted for. In weight they should be rather more than the malt used. Certificates should be procured for stocks of hops in cold storage or in hands of hop factors. See that the outstanding liability for duty on beer is brought into account.

BUILDERS, CONTRACTORS, ETC.

Balance Sheets. The special features are contracts and jobbing in progress, builders' plant, which is moved from one job to another, advances against contracts in progress (whether on Surveyors' Certificates or otherwise), loans secured on leases and on buildings in course of erection, etc. Inspect the various leases, building agreements, and contracts, note the conditions, and see that all charges and liabilities arising thereunder are taken into account or disclosed. See that proper records are kept as to the transfer of plant from one job to another, also that the plant is freely written down, and is scheduled and valued from time to time for the purpose of comparison with the values in the books.

Wages may be payable at many different places, and wages sheets, certified by the foreman and the pay clerk, should be produced in respect of each pay. An occasional surprise wages audit at the different points is recommended.

The book-keeping of many builders and of the smaller contractors is frequently defective, making it difficult to gauge the position as regards the apportionment of establishment charges to the contracts, the value of the work in progress, and the estimated cost to complete contracts, and impossible to make an unqualified report on the Balance Sheet. In the case of incorporated companies carrying on the business of builders or contractors, see whether the Articles of Association contain any provisions as to the way in which work in progress is to be dealt with in the accounts. As to cases where interest on capital during construction is being charged, see page 65.

BUILDING SOCIETIES

As to the accounts, see the form of Annual Account and Statement as prescribed for general use by the Registrar of Friendly Societies with the approval of the Secretary of State. The Forms include a Receipts and Payments Account, a statement showing the operations of the year, and a Liabilities and Assets Account, also a schedule divided into three parts, giving certain particulars as to any properties of which the society is in possession. The liabilities are to include the holders of shares, depositors, bankers, and also undivided profit (if any). The assets are to include mortgages of members, investments, and "balance deficient," if any. The books should be devised so that the various statements may be raised and checked as quickly as possible. The Auditor should be familiar with the provisions of the Building Societies Acts of 1874 and 1894, and with the rules of the society as to the raising of funds, the issue of shares, advances on mortgages, redemption of mortgages, restriction of borrowing, etc., and should see that the rules comply with the Acts. The members' Pass-books should be produced and compared to a reasonable extent with the Deposit Accounts. A useful precaution is to arrange that the Pass-books be numbered in consecutive order, and that the printer certify direct to the Auditor from time to time how many books have been issued, and the consecutive numbers impressed on them. A similar precaution may usefully be adopted as to Investment Ledgers, Deposit Ledgers, and Advances Ledgers.

To anyone familiar with the forms of account and the Acts, the audit presents no difficulty. The vouching of receipts and payments, the examination of securities, cash, etc., the verification of the rents received and paid, of the income from investments, and of the purchase and re-sale of property are common procedure. If necessary, suggest that an official be made directly responsible for the keeping of a clear record of all the properties mortgaged to the society (including any of which they have taken possession), setting out where the title deeds are deposited, where insured, and the dates premiums are payable; also to see that the premiums have been paid. The following form of certificate, though not compulsory, fulfils the requirements of the Acts—

We, the undersigned, ... , being *a person* who publicly carries on the business of an accountant at No. .... Street, ..., and ...., residing at ...., the duly appointed auditors of the above-mentioned Society, do hereby attest the foregoing Accounts and Statements, and certify that they are correct, duly vouched, and in accordance with law, and we certify that we have, and each of us has, at this audit, actually inspected the Mortgage Deeds and other Securities belonging to the Society, in respect of each of the .... properties in mortgage to the Society referred to in the foregoing Accounts and Statements.

It should be borne in mind that the sums received on deposit or loan should not exceed two-thirds of the amount secured to the society by mortgages from its members.

CHARITIES

The Balance Sheet, if there be one, is usually but a statement showing accumulations of income and any special capital funds on the one side, and investments, cash, etc., on the other, though these details are sometimes woven into the Income and Expenditure Account. The Auditor should ascertain what conditions attach to the various funds, and see that they are complied with so far as the accounts are concerned. He should ascertain the constitution of the charity, who are responsible for the management of the funds and empowered to make regulations, whether they have made any, and if so what they are. If by chance incorporated under the Companies Act as a company limited by guarantee, see that the Memorandum and Articles are complied with, and make a report as required by the principal Act. The War Charities Act, 1916, should be read, also the regulations made by the Charity Commissioners pursuant to Section 4 of the Act.

If there be a printed list of subscriptions and donations, the amounts should be totalled up and agreed with the totals shown in the accounts. See under what system counterfoil receipts are issued, and compare them sufficiently with the cash receipts. Miscellaneous receipts may be verified by reference to correspondence, memoranda, etc. Vouchers may not always be available, especially as regards remittances abroad, for example, to missionaries or others. The method of remittance should be ascertained, and vouchers produced at a later date.

If any income tax has been paid or deducted at the source from investment income, see that it is duly recovered. Payments under Schedule A on property owned by a charity, but not in its occupation, should also be repaid, or arrangements can be made to have the assessments cancelled. In the case of property in the occupation of a charity, exemption or repayment of tax paid under Schedule A and Inhabited House Duty may, subject to certain exceptions, be claimed. (As to which see any standard book on income tax practice.) Land Tax may also be saved in certain cases.

Note. Where the residue of an estate is left to a charity, and has not been distributed within the twelve months following the death of the testator, so much of the income of the estate as would have been income of the charity if the distribution had taken place at the end of that twelve months will be regarded as income of the charity for income tax purposes and income tax may be recovered (Finance Act, 1922, Section 30).

Before accepting an appointment as Auditor to a charity, the Auditor will do well to take steps to see that intelligible books are

being kept, counterfoil receipts issued in a businesslike way, vouchers properly filed and expenditure controlled.

CHURCHES AND CHAPELS

The Balance Sheets (if any) are, as a rule, simply accounts showing various Trust Funds and accumulations of income (if any) on the *Dr.* side, and investments and cash, and possibly a deficit, on the *Cr.* side. Sometimes also the fabric itself may be included in the Balance Sheet, and any debt outstanding in respect thereof. The Auditor should ascertain the constitution of the church or chapel, and who is charged with the administration of the funds, and see the trust deed (if any) regulating the administration of the funds and effects as a whole, or any of the special funds, and satisfy himself that the payments are in accordance therewith. The emoluments, salaries, etc., should be verified and vouched in the usual way by reference to agreements, minutes and vouchers. If there be any invested funds representing endowments, legacies, etc., they should be verified. If income-tax has been paid or suffered by way of deduction from income on investments, see that it is duly recovered. (See also under CHARITIES.) Where pew rents are charged, a summary showing the total letting capacity, the rents and total rental, should be prepared, and the total rental worked out and agreed with the receipts, after allowing for unlet sittings. If counterfoil receipts are given for the pew rents, they should be sufficiently examined. Sometimes Church officials attend on stated occasions to receive the rents, one officer receiving the money and entering the amount in the Cash Book, while the other credits the amounts in the Pew Rent Ledger, no receipts being given. The Cash Book and Ledger should be compared and agreed. The offertories should be entered in a suitable book, and the total initialed by two responsible officers of the church or chapel. Any special collections or receipts from special sources should be similarly recorded and authenticated. Depreciation of church fittings, books, etc., should be provided for.

CINEMAS

Balance Sheets. The special feature is the unexhausted value of films purchased, more especially if to be shown at a number of houses, and also sublet. Questions at once arise how quickly to write down the cost, leaving a balance as the unexhausted value of the films, and what should be charged to each house. How to spread the hire of films to be shown at a number of associated houses is another point to be settled.

The answer to these questions depends on the conditions in each case, and the agreements for the purchase or hire, or hire-purchase, of films should be closely scrutinized, as the conditions

are variable. Fixtures and fittings, including the sitting accommodation, are also a considerable item, depreciation requiring to be carefully considered. The sound financial plan is to write down the cost of films as quickly as possible. As regards checking the receipts (including tax) and payments arising in connexion with the house, the procedure does not differ from that which obtains in the case of theatres. (See under "THEATRES.")

CINEMA FILM PRODUCTIONS

The special duty of the Auditor in these matters is to study all the agreements for sales of films, whether for sales outright or hire-purchase, or simply hire. The conditions are very varied, but the majority of films should be written down quite quickly.

CLUBS

Balance Sheet. The principal items are usually the lease of the premises, the furniture and fittings and catering equipment, all of which should be adequately depreciated. Subscriptions received in advance, rents, rates, and taxes accrued, but not due, should be brought into account, and a due proportion of any payments which relate to the succeeding year should be carried forward. If, as is unusual, the accounts are not raised at the end of the club year, the subscriptions should be apportioned. Entrance fees are usually treated as income, sometimes described as "Extraordinary Income," and, subject to any provision in the rules of the club, there seems to be no object in treating entrance fees as capital, for the fees are not returnable and are not a liability.

To facilitate the book-keeping and the audit, the cash receipts should be in columnar form, the entrance fees and each class of subscription being distinguished, so that the total received in respect of each class of member is shown separately at the close of the year. A classified summary of the members should be compiled, setting out the members at the beginning of the year, the additions to the membership and resignations during the year as shown by the minutes of the committee or the governing body. The classified receipts, as shown by the cash receipts, should be agreed with this summary. As an additional precaution, the counterfoil receipts for entrance fees and subscriptions should be sufficiently tested. The fees and subscriptions should be paid direct to the club bankers. A list of subscriptions in arrear should be prepared and submitted to the committee. The conditions of membership should be noted, and care taken that any special sums besides entrance fees, payable on election, are duly accounted for. The check on the catering receipts and payments, bedrooms, baths, cards, billiard room, etc., follows that adopted in the case of hotels. (See HOTELS.)

If any part of the stock of wines or cigars is not the property of the club, but of merchants supplying the club, care should be taken that the stock is not included among the club's assets. In the case of golf clubs, the locker rents received should be agreed with the number of lockers actually let. Green fees should be checked with the Visitors Book, in which the green fees should be totalled up daily, and the daily total agreed with the amount entered in the Cash Book. Caddie fees should be agreed with the caddie master's register. There should be additional columns in the columnar Cash Book for green fees and locker rents. If it be a condition of membership of the club that the member take up a share in a company running the club, see that the numbers of entrance fees and of shares taken up agree.

A gauger should be employed to check the bar receipts, and his statements should be produced to the Auditor.

COLLIERIES

Balance Sheet. The special features are the capital outlay on pit sinking, on driving main headings underground, road and railway construction on the surface and below it, on development, and on workmen's cottages, "short workings" and wagon purchases under hire purchase contracts. In the case of a new colliery, the general principle is that all expenditure, less sales of coal, be charged to capital until coal is being got in quantity, when the Capital Account is closed, and development charged to revenue. This is a complex question of capital and revenue, upon which the Auditor should be guided by the Mining Engineer's reports and returns. On the mineral becoming exhausted, or if the pit be destroyed by accident, the whole of the capital outlay, including the cottages, may be of but little value. As a matter of sound accounting, the outlay should, therefore, be written down over not less than the estimated period during which coal in payable quantities will be available, after allowing for annual output, according to the calculations of the Mining Engineer. Alternatively, a reserve should be created, which may be calculated on the same basis and in either case charged at so much per ton as part of the cost of winning the coal. Pit timber used should, as a rule, all be charged to revenue.

Short Workings. Colliery leases usually stipulate for a fixed, or, as it is called, a "dead" rent, merging into royalties on a fixed scale per ton of coal raised, thus providing for a minimum rent in any event. If the tonnage raised in any particular period is insufficient to cover the dead rent, then the difference may be carried forward and applied in payment in another period when the royalties exceed the dead rent, provided this happen within a prescribed time limit. The difference between the dead rent and

the royalties is described as "Short Workings," and carried forward as a sort of contingent payment in advance, which must eventually be charged to revenue, though possibly in lieu of what would otherwise be additional royalties. Care should be taken that the short workings are written off on the expiration of the stipulated limit of time mentioned in the lease, or if there is no prospect of their being covered by tonnage raised.

Wagons. The wagons may be the property of the colliery owner or may be hired by him under a hire purchase contract spread over a number of years. The property in the wagons is only vested in the colliery owner on payment of the last instalment, and the wagons are security for due payment of the instalments. The colliery owner's liability is to pay certain instalments, consisting, in theory if not in fact, partly of principal and partly of interest, at certain dates for a term of years. Depreciation on the full value of the wagons in his possession is, however, a charge to Revenue Account, so that the wagons, when the property passes, will be represented in the books at their depreciated value. The full value of the wagons on a cash down basis is frequently entered on one side of the accounts, and the liability to the wagon manufacturer, also on a cash down basis, on the other side, the interest included in each instalment being added to the principal sum, and charged to profits each year, and the balance of the liability, on a cash down basis, brought down as the amount owing on account of principal. However convenient for purposes of calculating depreciation, this method of accounting does not represent the exact position. The liability is to pay certain instalments at certain dates on pain of seizure of the wagons if default be made. The aggregate of the instalments paid at any date, less the aggregate amount of interest included in the instalments (charged to Profit and Loss Account), is a contingent asset, the contingency being the due payment of the remaining instalments. The Auditor should see that the position is made quite clear.

Transactions. The quantities of coal got may be sufficiently ascertained from the wages records after allowing for coal consumed at the colliery and loss in screening, and compared with the sales. The Sales Agents' Accounts are also available to show the moneys to be accounted for. The system of recording local sales should be examined. Wages are a very heavy item in the accounts, and should be checked and verified in the usual way. The system of store-keeping should also be looked into. Depreciation is an important item, and the rates for each class of plant and machinery should be carefully considered. Cages and ropes are a special item, and should be written off at about 33⅓ per cent. Other special items are surface railways and underground tramways, for which 10 per cent should be sufficient. Horses and ponies

may be written down at fixed rates of depreciation or actual losses written off. For colliery tubs and such like, 10 per cent is a fair average rate. Stocks of coal are usually valued at the net selling price or under, and if the stock is not large and not increasing from year to year there is no objection to this method of valuation. Agreements with the railway companies should be examined, and care taken that all liabilities thereunder are brought into account.

Note. The agreed rate of depreciation for income tax purposes on railway wagons not owned by railway companies is $6\frac{1}{4}$ per cent on written down value in the case of all wagons owned by traders. In the case of railway companies, the actual cost of renewals is allowed year by year in lieu of depreciation.

COLONIAL BANKS

The chief receipts of the branch in England of a Colonial bank are money received from depositors. These amounts should be checked with the counterfoils of the Deposit Receipt Books.

Deposits paid off during the period should be checked with the surrendered deposit receipts.

The balances should occasionally be checked with the Deposit Ledgers.

When the bank lends money to stockbrokers from settlement to settlement, the Auditor should attend before any variation takes place in the securities deposited, and examine them with the borrowing notes, and also ascertain that the advances are made on sufficient margin.

The Cash Book should be checked with the Loan Ledger, and the balances in the Loan Ledger should be checked with the list of loans agreeing with the General Ledger. Bills receivable should be examined with the bills themselves as entered in the Bills Receivable Book. The Bills Payable Book and Bills Receivable Book and the Bills Negotiable Book should be checked into the Head Office Account, for the purpose of ascertaining that the head office has been properly debited and credited with the amounts paid or received.

The books containing the drafts issued on the head office and letters of credit should also be checked with the Head Office Account.

The balance of the Head Office Account should be agreed with the balance appearing in the head office books according to the statement sent over from the head office for that purpose.

A number of Customers' Pass-books available should be checked with the Ledger.

CONTINENTAL AUDITS

Book-keeping is on a uniform system throughout most of the Continent, and is based on the Journal, the use of which is

compulsory in most countries. The Auditor should procure a translation of that part of the commercial code in each country which relates to the books which traders must keep, from which it will appear that, if the Code Napoleon is in force, in addition to the Journal the trader has to keep—

(1) An Inventory Book (like the English Balance Sheet Book) which must contain each year a Balance Sheet and Profit and Loss Account, an inventory of his real and other property, stocks, debts, and credits, all made up to the same date, and signed by him.

(2) A record of the letters and telegrams received by him.

(3) Copies, in a copy book, of the letters and telegrams sent by him.

In addition to these books, companies must keep a Share Register, a Minute Book of directors' meetings, and a Minute Book of shareholders' meetings The books have to be kept in order of date. There must be no blank spaces, and no writing between the lines or in the margin. No erasures may be made, and if any alteration be necessary, it must be made in such a way that what has been altered is quite legible. Before the Journal can be used, each folio must have been numbered and signed by a Judge of the Tribunal of Commerce, or by a magistrate in the domicile of the trader or some official appointed for the purpose. A certificate is inserted on the last page of the books, certifying the number of folios therein, to which certificate the Magistrate or Judge or official must add the date and his signature. The form of the certificate is usually as under—

This book of 40 pages of the Company A. B. C. has been checked by the undersigned.

....date
A Judge of the Court
.... Signature

The Journal has to be presented to the Court or to the Magistrate once a year for certification, which must be made under the last entry. The trader is compelled to keep the books for a prescribed term of years. The official visé and certificate prove the books to be authentic, thus making the production of false books very unlikely. The entries in the books must be tested by the Auditor in the usual way, the official control not extending to the entries. The Journal is not necessarily a daily detailed record of transactions, but may be a monthly record of sales and purchases, cash receipts and payments, bills accepted and endorsed, with the usual adjusting and closing entries. The details are given in subsidiary books, or, in some countries, in subsidiary Journals, which may also require to be viséd, stamped, and officially controlled. The Journal may be in columnar form, only the annual

totals being posted to the principal Ledger, or in common form, in which case the contents are posted to the Ledgers in detail. The balances of the accounts in the principal Ledger should be agreed with the total of the balances of the subsidiary Ledgers, which are posted from the subsidiary Journals or books referred to above. This is similar to the English method of raising Bought and Sold Ledger Accounts in the Private or Impersonal Ledgers, and agreeing the balances with the personal balances in the Bought and Sold Ledgers. The Auditor can conveniently vouch the Journal by reference to the Day Books and Cash Books, and can test these books as far as may be necessary by reference to invoices, vouchers, correspondence, etc. In foreign accountancy, great care is also taken to furnish reliable detailed information by means of subsidiary columnar books used for costing and statistical purposes. The Ledgers are sometimes sub-divided, one being kept for capital items, another for Trading and Profit and Loss items, debtors and creditors having separate Ledgers. Loose-leaf books would not be accepted in foreign Courts, and can, therefore, be used only for the purpose of subsidiary records.

In the case of a company, the Auditor should procure a translation of the Articles of Association so far as they affect the accounts.

CO-OPERATIVE STORES

Some of the invoices for purchases should be compared with the Receiving Sheets and Invoice Journal, for the purpose of ascertaining that the goods paid for have been actually received, and have been charged to the Purchases Accounts of the various departments. This will also prevent goods received being sold or taken into stock before the Department has been charged with the purchase; it will also be a check on the Departmental purchases (if any) in cases where a separate book is not kept for the purpose.

As regards sales, certain of the duplicates of the bills handed to customers should be compared with the Abstract prepared by each salesman, and the totals of the Abstracts should be traced in the "Dissecting" Journal, and thence to the Cash Book. Should there be any credit sales, some of the duplicates should be checked with the Journal reserved for each Sales Ledger.

DISCOUNT HOUSES

The bills on hand should be checked with the Bill Books for the day previous to the audit, the additions of the books checked, and the amounts compared with the entries in the Bill Balance Book.

The securities belonging to the House should be compared with the Security List, and those appearing on the List as being in the hands of the depositors or the bank for safe custody should

be checked with the receipts given by the holders of such securities. The securities held against loans should be verified with the entries in the Contract Lists, and the amount of loan and security checked into the Summary.

The prices on the list should be checked with the Stock Exchange Official List of the day, to ascertain that the loans are fully covered.

The balances of the following Ledgers should be checked—

"Deposits without Security" Ledger, including interest unpaid, constituting a liability in the Balance Sheet.

"Deposits against Security" Ledger, including interest unpaid, and constituting a liability in the Balance Sheet, the hypothecated securities, consisting of bills discounted and companies' securities, appearing *per contra* among the general assets.

"Loans" Ledger, being the balances of amounts advanced by the House, including interest unpaid and covered by security.

"Security" Ledgers. These show the amount of security including bills discounted in the hands of depositors against their deposits with the House.

The "Calendars" should also be checked, as they show the bills due on each date and the amount rediscounted. They also furnish the particulars required for the Rebate Account, which shows the amount debited to the Profit and Loss Account, on account of discount on bills discounted, which will mature in a later period. In the Statement for Rebate the daily amounts of bills falling due are entered, and the balances due after deducting the bills rediscounted, the number of days from the date of the Balance Sheet to maturity, and the amount written back as rebate, calculated on the average rate of the discount agreed upon.

As regards the bills discounted, the balances in the Ledger may be checked as follows: With the bills on hand, with those held for collection, and those out for collection, with the bills deposited as security, and with the bills rediscounted as in the Ledger balance.

ESTATE ACCOUNTS

Balance Sheet. The principal item is the value of the estate and properties, which should be taken at cost, less any necessary depreciation. Profits or losses arising on sales of any part of the estate or properties should be added to or deducted from capital in the case of individual owners. If owned by a company, one of whose objects is to buy and sell estates, the profits and losses come into revenue unless the Articles otherwise provide.

Transactions. At the first audit the terrier of the estate should be produced, and the rent rolls checked with it, also with the respective leases and agreements. The collections at the rent

audits, together with property tax deducted, allowances, etc., and allowance for arrears, should be agreed with the total rental as shown by the rent roll. Arrears should be traced from one quarter to another until accounted for. Any allowances, reductions, or concessions made should be as authorized in writing by the owner or the directors, as the case may be. Royalties receivable should be compared with the royalty agreements, also with the mining surveyor's certificate, if the owner is represented by a surveyor. See that salaries and commissions are as provided under agreements or authorized in writing.

Sales of timber, and such like, should be vouched by Accounts Sales, or correspondence may be available. In the case of a private owner, the question of taxation should be carefully gone into, for tax is deducted at the full rate from rents under Schedule A, and there may also be Schedule B assessments on property owned and occupied. The Auditor should see that any claims for allowances, reliefs, etc., including insurance premiums paid, are duly submitted.

FARMERS' ACCOUNTS

Many farmers live in the patriarchal manner, each member of the family living on the farm and taking part in the work of the farm, including the book-keeping. The books consist of a Bank Pass-book, some Note Books, and possibly a Debtors' Ledger of sorts. Private expenditure is usually intermingled with farming outlays. Private payments made by cheque can be distinguished, but frequently cash receipts or cheques cashed for wages are applied to private purposes without any adequate record, making it impossible to prepare precise accounts. Although expert accounting is seldom possible, the Auditor can at least arrange to have full details of all receipts entered in the Bank Paying-in Book, including, for the purpose of checking live stock, the number of horses, cows, calves, sheep, pigs, etc., sold. Full details of payments should be entered on the counterfoils of the cheque books, also giving particulars as to live stock purchased. A Wages and a Petty Cash Book with a few suitable columns should be introduced, and a systematic filing of vouchers. From these sources columnar Cash Books of receipts and payments can be written up, and with lists of outstanding debtors and creditors duly classified, and a summary of stocks at the close of the year, and of plant, machinery and implements, sufficiently satisfactory accounts can be raised.

Accounts in this form will be accepted by the taxing authorities, a point of importance to all farmers. The accounts should be raised at the end of March, when stocks, as well as growing crops, are at their lowest, that also being a convenient date for taxation

purposes. The live stock on hand should be valued at average cost price, and the net profit or loss on sales written off. In the case of dairy farmers, dry cows are frequently being sold and replaced, and the loss on sales is a constant feature in the accounts. As regards horses, if the risk of loss by accident or disease is covered by insurance, provision for depreciation need not be excessive. In some cases horses are valued from year to year. The value of the natural increment of live stock is also a question to be taken into account if of sufficient importance. In sheep farming the increment is usually brought in at some more or less arbitrary value, the average cost being a nominal one which costing purists might find it hard to determine.

Where farming is on a large scale, and expert accounts are prepared, the following points require to be more carefully considered and brought into account with more precision—

(1) The value of growing crops from year to year, cost of seeds, etc.
(2) Unexhausted cost of manures.
(3) Stocks of farm produce on hand.
(4) Crops and produce not realized.
(5) Depreciation of plant, machinery and implements.
(6) Valuation of live stock—

- (*a*) for breeding purposes,
- (*b*) for use on farm,
- (*c*) for sale.

(*a*) and (*b*) should be valued at average cost, any profit or loss on sales being duly carried to Profit and Loss Account. (*c*) should be taken at a careful and conservative valuation so as not to anticipate profits. As regards profits, it is true the law of averages should correct any under-valuation or over-valuation over a period of years, unless stock is continually increasing, but for Balance Sheet purposes a prudent valuation is the only sound one.

The income tax conditions attaching to farmers are exceptional, and should be mastered by the Auditor, who should take care to see that the various assessments under Schedules A and B all relate to the property occupied by his client and do not overlap, also that the farmer gets the relief to which he is entitled, particularly in respect of earned income. If the farmer does not apply to be assessed on profits, the fact that the Schedule B assessment is on earned income may be overlooked. It should be seen that notice for claims in respect of farm loss, if any, is duly given.

Note. If the farm-house is not occupied by the farmer, but sublet, Schedule B is not chargeable on it.

FINANCIAL HOUSES

So far as the accounts relate to dealing in stocks and shares, the books and accounts should be modelled on those of stockbrokers. The Register of Contracts, which should be in columnar form, is vouched by reference to brokers' contract notes. As regards underwriting transactions, the Auditor should see the underwriting agreements. Underwriting commissions received should not be included in profits earned without taking into account possible losses on shares with which the house may have been left, as a result of the underwriting transactions.

No other points are likely to arise which have not already been dealt with.

FRIENDLY SOCIETIES

These societies are governed by the provisions of the Friendly Societies Acts, 1875 to 1908, which provide for a special form of Audited accounts, also for a quinquennial valuation.

There is a vast amount of detail in the books, and the student cannot do better than read the volume on "Friendly Societies" in *The Accountant's* Library Series, both as to the books and as to the conducting of an audit.

GAS UNDERTAKINGS

Gas Companies. These companies are mostly Parliamentary Companies, and the Auditor's duties will be regulated accordingly. The "Clauses Acts" include the Gas Works Clauses Acts of 1847 and 1871. In the latter will be found the prescribed form of accounts, including Statement of Share and Loan Capital, Capital Account, Revenue Account, Profit and Loss Account (net revenue), Reserve Fund Account, General Balance Sheet, Statement of Coals, Statement of Residual Products, and various provisions as to the Reserve and Insurance Funds, and as to a sliding scale regulating profits and prices.

A question of primary importance is the distinction between capital and revenue, which is one of the principal aims of the prescribed form of accounts. On this point, the Auditor should have a certificate from the company's engineer, and an explanation of the principle on which the engineer distinguishes between capital and revenue. Ample provision should be made for depreciation. Agreed rates of depreciation for income tax are as follows—

3 per cent on written down value of gas holders.

10 per cent on written down value of meters, cookers, and gas fires.

Transactions of undertakings such as Electricity, Gas, and Water Companies. As to the internal control over collections,

electricity rentals, water rates, gas residuals, sale and hire of fittings, checking rateable value in Rate Books, losses from unoccupied property, recoverable and irrecoverable arrears, deposits, prepayment (coin) meters, Rental Ledgers, the student is advised to read *An Internal Municipal Audit*, by Ernest Collins.

A gas company established before 1847 was authorized by its special Act to pay dividends limited to 10 per cent, and when that sum was reached, if there was a surplus, the price of gas was to be reduced; there was also a provision for a Reserve or Contingent Fund, to be limited to £5000; afterwards the dividends and interest thereon were to be no longer invested, but applied to any of the general purposes of the undertaking to which the profits of the company were applicable. By another Section of the Act it was enacted that if in any year after the passing of the Act the profit should not amount to 10 per cent per annum on the amount paid on the shares (whether such deficiency should have occurred before or subsequent to the formation of the Contingent Fund), such a sum might be taken from the Contingent Fund as, with the actual divisible profits of such year, would enable the company to pay a dividend of 10 per cent per annum.

The company sought to apply a sum of £3990, the amount raised of the Contingent Fund, to the payment of back dividends of past years. It was held that as long as the company paid 10 per cent they could not touch the Contingent Fund and that they were not entitled in any one year to divide more than 10 per cent, whether from profits or Contingent Fund, and were not entitled to apply the Fund in making up the dividends of past years to 10 per cent.—*Chamberlain* v. *New Worcester Gaslight Co.*, *Journal of Gas Lighting*, 8th June, 1875; *The Times*, 5th June, 1875.

GOLD MINING COMPANIES

The Auditor at the head office depends upon the returns received from the mines, which, whether summarized or in detail, should distinguish between Development Account, Erection of New Works and Working Account. If possible, copies in detail of the Mines Cash Account (with duplicate vouchers and certificate as to the balances on hand), and of the Bought Day Book and Sales Day Book, should be available. Shipments of gold or sales of gold or of stores to local banks should be recorded in the Sales Day Book. Copies of the Mines Journal and closing entries should also be sent, and a periodically agreed list of Ledger balances. A duplicate set of Mining Accounts can then be raised at head office, and examined by the Auditor. The head office remittances in cash or kind should be agreed with the corresponding items in the Mines Cash Book, allowing for what is in transit. Certified

inventories of the stores, works, buildings, and fixed plant, movable plant, live stock, stock of ore on hand, should also be produced.

The consulting engineer should certify as to the additions to plant and buildings during the year, that it is all chargeable against capital expenditure, that there has been no exceptional depreciation of the company's property, or any loss or damage thereto, and that the provision for ordinary depreciation is sufficient. The Development Account, including expenditure on shafting, should be gradually written off by a tonnage charge against ore raised. The Auditor should see what provision is made for redemption of capital according to the estimated life of the mine. For gold sold, the Bullion Brokers' Accounts Sales should be seen.

HOTELS

Balance Sheet. The principal items are leases, furniture and fittings, linen, plant and catering equipment, stores, wine, tobacco and cigars, visitors' accounts, also outlays on painting, papering and decorating, which may sometimes be spread over a period of years.

Transactions. In a well organized hotel control clerks check the Tabular Ledgers from day to day with the returns from the office as to rooms let, waiters' returns as to meals, liquor, etc., chambermaids' returns as to baths, fires, and other extras. The Auditor may also test the Ledger by occasional visits while the returns are still available. He should also check to some extent the casts and carry forwards in the Ledgers, and check the cash received to the Cash Book. With a well devised columnar Cash Book, the cash may be agreed in total by extracting the Ledger totals for a period. The wages should be checked with the totals of the certified Wages Book. The wines sold should be checked with the Cellar Returns, and the stores with the Store Returns, Billiard Room receipts by the Billiard Room Book, and the bar receipts by the Bar Attendants' Returns as checked by a gauger from time to time.

The Register of Invoices (in columnar form) should be examined to see that nothing is charged to capital which should be charged to revenue. The Servants' Keep Cost Book should also be examined. The stocks as taken should be compared with the corresponding Ledger Accounts, and any difference looked into. As an amusing instance of internal control, in some hotels the affixing of a hotel label to a visitor's luggage indicates to the hotel porter that the visitor has paid his dues, and that his luggage may be removed. From this point of view the bearer of much be-labelled baggage unconsciously carries his credentials with him.

An important point is to see that sufficient depreciation is

written off, repairs and renewals being taken into account in settling the rates.

The counting of cash in foreign hotels requires a knowledge of foreign currencies and of exchange values.

INSURANCE COMPANIES

Balance Sheet. The Balance Sheets of all insurance companies present similar features, i.e. loans, investments, reversions, outstanding premiums on the one side, and on the other side the various funds, claims admitted or intimated but not paid, annuities due and unpaid surrender values, unclaimed expenses and commission outstanding. The investments should be dealt with in the manner already described. (See page 96.)

The Auditor should be conversant with the Assurance Companies Act, 1909, applicable to Life, Fire, Accident, Employers' Liability, and Bond Investment Companies, with some special provisions as to Accident Insurance Companies. The Act provides, *inter alia* that separate accounts be kept for each class of insurance transacted, and to it are scheduled forms of Balance Sheet, Revenue Account and Profit and Loss Account. Provision is also made for the deposit of the accounts with the Board of Trade.

Transactions. The total premium income can be computed by reference to the Registers of Policies, Renewals, Lapsed Policies, etc., and agreed with the receipts after allowing for arrears. The Agent's Accounts should be compared with the Ledgers to a reasonable extent. Agent's expenses and commission should be vouched in the ordinary way, the Auditor seeing that they are in accordance with the agreed terms. For claims paid, cancelled policies will be produced, and claims intimated may be compared with the Claims Book. For surrender values, policies should be available, and receipts for the money paid. The Re-Insurance Account should be carefully examined. In the case of Life Companies, the Act provides for a quinquennial valuation, the result of which should be given effect to in the accounts. In the case of other companies, the provision for unexpired risks is usually based on a proportion of the premiums.

The Balance Sheet must state how the values of the Stock Exchange securities are arrived at, and a certificate must be appended, signed by the persons who sign the Balance Sheet, to the effect that in their belief the assets set forth in the Balance Sheet are in the aggregate fully of the value stated therein, less any Investment Reserve Fund taken into account. In the case of a company transacting life assurance business or bond investment business, this certificate is to be given on the occasions only when a statement respecting valuation under the Fourth Schedule is made pursuant to Section 5 of the 1909 Act.

Marine Insurance. The account for each year is kept open for three years before being finally closed, the claims being charged to the year in which the premiums are received.

Fire Insurance. There is no rule of law that in assessing a fire insurance company to income tax, the total premiums receipt for the year, after deducting the losses and disbursements for the same period, are to be taken as the profits of the company, without making any allowance for unexpired risks on policies outstanding at the end of the year; but where it becomes necessary to have recourse to some form of estimate, that method will be adopted which approximates most nearly to the truth.

Where, therefore, it was proved, on an appeal by a fire insurance company against an assessment, that it was the practice of the company, in making up its annual accounts for the purpose of ascertaining the profits for distribution among its shareholders, to carry forward to the succeeding year a certain percentage of its premium receipts as an allowance to meet unexpired risks on outstanding policies, and that this percentage was a fair and reasonable allowance for that purpose, and the figures, on the triennial average prescribed by the Income Tax Acts, showed a large increase in the amount of such allowance for the year of assessment.

Held, that in the circumstances it was competent to the company to make an allowance in respect of unexpired risks and that the increase in the allowance formed no part of the profits or gains of the year.—*Sun Insurance Company* v. *Clarke*, [1912] A.C. 443.

JUDICIAL TRUSTEES

In auditing the accounts of Judicial Trustees, the Auditor should peruse the following documents, which, in accordance with No. 4 of the Rules under the Judicial Trustees Act, 1896, have to be supplied by the applicant for the use of the Court when making the application for the appointment of a Judicial Trustee.

A short description of the trust.

Short particulars of the trust property, with an approximate estimate of its income and capital value.

Short particulars of the encumbrances (if any) affecting the trust property; also the complete statement of the trust property, accompanied by an approximate estimate of the income and capital value of each item, as required by Rule 8 to be furnished by the Judicial Trustee to the Court.

LOCAL AUTHORITIES

The Auditor of the accounts of local authorities should be familiar with the various Acts relating to local authorities

generally, also any special Acts relating to a particular authority. The more important Acts are as follows—

Municipal Corporation Act, 1882 (Borough Fund Act).
Public Health Act, 1875 (Sanitary Authorities Act).
Local Government Act, 1888 (County Council Act).
Local Government Act, 1894 (Parish Council Act).
Local Government Act, 1899 (District Council Act).

The important points are the exercise of borrowing powers, Sinking Fund arrangements, and the class of expenditure made, which must be strictly in accordance with the powers conferred on the various authorities. The Auditor will, therefore, have to carefully vouch and examine the expenditure, also the borrowing powers and the exercise of such powers.

The receipts are usually controlled by a thorough system of internal control, and the Auditor need, therefore, only test the figures sufficiently. With regard to these matters, and also to the many activities undertaken by local authorities, such as gas, electric lighting, tramways, etc., the student should read *An Internal Municipal Audit, The Accounts of Local Authorities* (Collins), in which the system of control is lucidly set out, and Whitehead's *Municipal Audit Programmes* and *Municipal Accounting Systems.*

MERCHANTS' ACCOUNTS

Balance Sheet. Merchants frequently make advances from year to year to estate owners against ensuing crops. These debts should be carefully scrutinized, to see that interest and charges are not being loaded on to debts which may prove to be bad or doubtful. The "run" of the accounts should be watched from year to year. Ascertain whether any security is held in respect of any advances, and, if so, see it. Verify deposits on account of freight or warehouse charges, and brokers' balances, seeing any warrants held in respect thereof.

Transactions. To check the transactions effectively, the Auditor should make himself conversant with the various shipping and mercantile documents, such as bills of lading, shipping invoices, landing accounts, warrants, weight notes, accounts sales, consignment accounts, and the procedure relating thereto, also the practice as to freight and warehouse charges, marine insurance, brokers' commission charges, interest and rebates.

MOTOR BUSES AND TRAMWAYS

Motor Buses. Balance Sheet. The special item is the "fleet" of buses. The Auditor should ascertain the terms on which they have been acquired, and if under hire-purchase agreements, see that the

facts are set out in the accounts, and capital and interest duly distinguished. Depreciation written off should be of an ample character, the agreed rate of depreciation for income tax being 20 per cent on the written down value.

Tramways. Balance Sheet. The special items are the permanent way, electrical equipment of the line, power stations, cars and equipment. Depreciation in relation to repairs and maintenance is an important factor, having regard to the risk of obsolescence.

Transactions. As regards both buses and trams, the system by which receipts are controlled is manifest to the passenger. The traffic receipts may be tested by the Auditor to a reasonable extent, and the expenditure vouched with an eye to the allocation between capital and revenue. Receipts from advertising is a substantial item usually let out to contractors whose accounts are available for vouching purposes.

NEWSPAPERS, PUBLISHERS, ETC.

Balance Sheet. The special items are goodwill, copyright, printing machinery, type, unexpired subscriptions and advertisements, contributors' accounts, and stocks of books and paper. Printing machinery should be depreciated at from 7½ to 15 per cent, cost of new machines and renewals being added to capital. There are many styles of type in use for newspapers and magazines, and the type should be depreciated heavily up to 33⅓ per cent if in constant use. Sales of old type should be brought into account and deducted from the Type Account. The Auditor should see that the goodwill and copyright are not swollen by diverting to capital what should be charged to income.

Copyright is sometimes valued from year to year, and written down according to circumstances. Writing-up is a dangerous practice, and unsound financially, since it adds to profits what has not been realized, but is locked up in capital.

Subscriptions and advertisement receipts should be carefully apportioned, unexpired subscriptions and advertisements paid in advance being carried forward. Stock of books should be certified as to quantities and value, which may be tested to some extent by reference to sales and selling prices. The value should not exceed cost, and in many cases should be written down quite quickly.

Transactions. There is much detail in newspaper and publishing accounts, and a well organized system of accounting and control, as in the case of all large undertakings, is the only effective safeguard against irregularities.

Only a continuous daily audit would enable all the transactions to be overhauled thoroughly.

As regards advertisements, a marked copy of the paper may be

checked with the Advertising Day Book at intervals by the Auditor, but this check should be carried out continuously by a control clerk as part of the internal organization. Sales may be tested by reference to the Distribution Register. Sales of waste paper, type, etc., should be certified to by a responsible official. The Subscription Ledger may be tested by reference to the subscription list. Expenditure on stamps should be controlled by internal organization. Stocks of paper may be compared with the Paper Stock Book. The money paid to contributors is vouched in the usual way. Authors' agreements should be examined, so as to see that royalties are duly provided for.

Depreciation. Rates for income tax.

Engines, Boilers, and Shafting: 5 per cent on written down value.

Printing and Binding Machines: 7½ per cent on written down value.

Type if not dealt with by way of renewals: 10 per cent on written down value.

OIL COMPANIES

The oil industry includes—

Production.
Transportation and storage.
Refining.
Marketing.

In the case of producing companies, the outstanding feature is the amount to be written off the wells for amortization and the depreciation to be written off those assets whose usefulness will terminate with the life of the wells. The amount to be written off depends upon the estimated life of the wells and is computed under expert advice. Otherwise the general features in the accounts of oil companies are covered by the usual auditing procedure.

PARLIAMENTARY COMPANIES

Parliamentary companies are companies incorporated by special Acts of Parliament. These Acts form part of the law of the country, and must be strictly observed. As a matter of convenience, the special Acts usually incorporate in whole or in part what are known as the "Clauses Acts," including the Companies Clauses Act, 1863 and 1869, as amended by the Companies Clauses Consolidation Act. 1888 and 1889, respectively, also the Land Clauses Acts including—

Lands Clauses Consolidation Act, 1845.
Lands Clauses Consolidation Acts Amendment Act, 1860.
Lands Clauses Consolidation Act, 1869.
Lands Clauses (Umpire) Act, 1883.

There are special Acts relating to Railways, Harbours, Docks and Piers, including—

The Railway Clauses Consolidation Act, 1845, and the Railways Clauses Act, 1863.
The Harbours, Docks, and Piers Clauses Act, 1847.
The Waterworks Clauses Acts, 1847 and 1863.
The Electric Lighting (Clauses) Act, 1899.
The Tramways Act, 1870 (Parts II and III).
The Markets and Fairs Clauses Act, 1847.

The Railway Companies Act, 1867, the Regulation of Railways Act, 1868, and the Railway Companies (Accounts and Returns) Act, 1911, also apply to every railway company, and the Electric Lighting Acts of 1882 and 1888 apply to all electric lighting companies. The Insurance Companies Act of 1909 applies to all insurance companies, whether they be Parliamentary Companies or not.

The Auditor must, therefore, be conversant, not only with the special Act, but with the Acts incorporated (which are specified in the special Act under the heading "Incorporation of Acts"), also with all the general Acts. Special Acts govern the procedure of the company, including the raising of capital, issue of stocks and shares, limitation of dividends, calls, forfeiture and surrender of shares, borrowing powers, and all the other matters usually provided for in the Memorandum and Articles of Association of a company registered under the Companies Act. A special feature is the double account system distinguishing capital and revenue, the working of which may be mastered by reference to the accounts of any Parliamentary Company.

RAILWAYS

The important railways are all Parliamentary Companies, and are governed also by special Acts relating to railway companies, and the form of accounts is regulated accordingly. Many and elaborate forms of accounts are prescribed by the Railway Companies (Accounts and Returns) Act of 1911, with which the Auditor must make himself conversant. The Auditor is required to certify that the accounts contain a full and true statement of the financial condition of the company, and that the dividends proposed to be declared on the stocks and shares of the company are *bona fide* due thereon after charging the revenue of the half-year with all expenses which, in his judgment, ought to be paid thereout. Even in the least of railways the amount of detail is very great, and the Auditor must rely mainly on certified summaries as to receipts, the internal control being of a very complete nature. The expenditure should, however, be very carefully

vouched with a view to seeing that capital and revenue are properly distinguished, and is authorized, for example, the carrying on of a hotel business. As regards railway wagons, in the case of railway companies the actual cost of renewals year by year is allowed for income tax purposes in lieu of depreciation.

Money borrowed for the purpose of completing a railway line is not payable out of profits, but debts incurred for rails, stations, and the like are payable out of profits.—*Corry* v. *Londonderry and Enniskillen Railway Co.* (1860), 29 Beav. 263.

RUBBER COMPANIES

Balance Sheet. The special feature of importance is the cost of the estate and the expenditure thereon and on development, the essential question being whether the division between capital and revenue is on sound lines. The Estate Manager's monthly report, which includes a Cash Account and a summary of transactions in Journal or other form, should distinguish between capital outlay on extensions, upkeep of immature areas, buildings and manufacture, upkeep of rubber in bearing, general charges, etc. Outlay on the thinning down of trees, which is considered essential to good cultivation, should usually be charged to revenue. A percentage of the general charges, and sometimes also of the London administration charges, is frequently charged to the Estate Account, by reference either to the trees tapped and the total trees on the estate, or to acreage in bearing and in course of development and total acreage. This addition to capital is quite justifiable, but in order to keep down capital some companies write off the whole of the charges to revenue, and even apply premiums on shares to writing down the cost of the estate. The productive life of rubber trees is not definitely known at present, though forty years is said to be the probable average limit. If the trees are thinned out, and trees which have become unproductive for any cause are replaced out of revenue, there would appear to be no object in writing down the cost, as the value of the estate is being maintained, but successful companies frequently do so for financial reasons, thus creating internal reserves, or, as is preferable, they build up reserves which are disclosed on the face of the Balance Sheet.

Transactions. Remittances from head office to the local agents and by the local agents to the estate manager or managers can all be agreed by reference to the Cash Accounts of the respective parties. The Managers' and Agents' Accounts set out any local sales of rubber or of catch crops, such as coffee. Shipments of rubber are advised by cable (confirmed by mail) as soon as the rubber is packed in cases for shipment. Cases in common use contain about 280 lb. of sheet, or 180 lb. of crèpe rubber. The

decoded cables and advices should be available, if required, for production to the Auditors, also the Accounts Sales of the local agents and the London selling brokers, enabling the whole crop to be traced and sales verified. Stock in transit may be verified by the advices or by the subsequent Accounts Sales when the stock has been disposed of. Stock on the estate is certified to by the manager or local agents, stock at the port by the agents there. The value of stock unsold is usually estimated by the Directors or the Managers, and the amount disclosed as a separate item in the accounts. The whole of the crop may, however, be sold under forward contracts at an agreed price. Any difference in exchange should be adjusted in the usual way. The Manager's report also contains a statement of the acreage, the trees on the estate which are being tapped, specified according to girth, so that the rubber produced per tree or per acre can be deduced from year to year. The production varies, but it is said that an average of 4 lb. per tree or 400 lb. per acre is a fair result, though trees have been known to yield 100 lb. per annum.

The title to the rubber estates may be vested in a local company, whose shares are held by an English company, which finds the capital, direction, and management. Strictly speaking the actual assets of the English company are the shares in the local company, together with any sums advanced and laid out on the estates. The accounts, as prepared, ignore this position, but a note is usually made on the accounts drawing attention to it.

SAVINGS BANKS

The extracted list of balances should be checked independently of the office staff. The balances shown in the Deposit Ledgers should be marked off consecutively, the Auditor's assistant taking the list of balances as prepared by the staff and calling out the amounts entered therein. The total of this list should be checked and compared with the total liability shown by the account "Depositors" in the General Ledger, and the list should be certified by the Auditor to be correct.

The interest credited to depositors should be tested by certain accounts taken at random.

The balance at the close of the half-year or other period fixed for audit should be verified both as to cash in hand and as to the Treasurer's balance, or preferably the Secretary or Actuary should pay into the Treasurer's account all cash in hand at the close of each period. A reference to the Bank Pass-book should not be regarded as sufficient evidence of the balance in hand, but a formal certificate from the Treasurer or banker should be called for.

No audit of Savings Bank Accounts can be considered complete

unless it comprises an independent examination and comparison with the Deposit Ledgers of depositors' Pass-books as presented at the Bank. For this purpose the Auditors should frequently attend at the Savings Bank and should carry out the comparisons in question to such an extent as will ensure the examination of at least 10 per cent of the Pass-books extant in the course of the year.

The frequency of the audit is fixed by the Trustee Savings Bank Act, 1863, at a minimum of once each half-year, but it should, if possible, be continuous as to examination of Pass-books, and the assets and liabilities should be examined in total each quarter. The periodical meetings of Trustees and Managers (or Committee of Management) should coincide with the periodical audits, and the Auditor should report direct to them.

The Auditor should examine the accounts of the National Debt Commissioners for transfers, purchases, sales of stock, interest, etc.; he should also ascertain that the statutory limits of yearly (£50) and total deposits (£200) are not exceeded.

In the case of banks making special investments under Section 16 of the Act of 1863, the Auditor should verify the securities held by the Bank for moneys advanced from the funds of the Special Investment Department, and should state in his report the manner in which this has been done.

SHIPPING ACCOUNTS

Balance Sheet. The special items are the fleet of steamships, motor-vessels and/or sailing vessels, the uncompleted Voyage Accounts, outstanding freights and agents' balances, and the Insurance Fund where companies undertake their own underwriting. The ships should be valued at cost, less depreciation. The agreed rate for income tax is as follows—

Steam Ships and Motor-vessels, 4 per cent on prime cost.
Sailing Vessels . . 3 ,, ,, ,, ,, ,,
With an addition of 2 per cent on that part of the prime cost which relates to refrigerating plant and insulation.

Revised arrangements were come to between the revenue and the Chamber of Shipping in January, 1927. The rates on prime cost were not altered but new rates of allowances were given for second-hand vessels and for capital additions made during the life of the ship. (See *The Accountant Tax Supplement*, 30th March, 1929, and 8th March, 1930, for full details.) It is important to see that in addition to ordinary depreciation the shipping company provides sufficient depreciation to write off all such capital additions over the ship's life. During times of depression in the shipping trade when freight rates are low, it may be found

that the company has made inadequate provision, or none, for depreciation of their tonnage, and this matter should be investigated.

Profits on ships sold may be divisible as revenue if it be one of the objects of the company to buy and sell ships, and there is nothing to the contrary in the Articles of Association. The profits are, however, usually applied to writing down the cost of the fleet. Any losses on ships sold will be a charge to revenue.

Transactions. There is usually a complete system of internal control, and the Auditor will, therefore, deal mainly with certified summaries of freights and passage money, testing them as far as he thinks necessary. In important companies a separate Ledger is kept for each ship, and a separate account for each voyage, which can be checked by reference to the captain's or purser's Cash Book, the agent's accounts, and the usual trademen's bills. The Cash Book should show the moneys supplied to the ship, either from the head office, or by the agents at the various ports. Cash in hand should be carried forward from one Voyage Account to another. The Auditor should see that any wines, slops or stores on hand at the end of a voyage are carried forward to the next Voyage Account. The Allotments Book should be examined here and there, also the portage bills. Passage money can be verified by reference to the agents' accounts. The separate manifests or copies of bills of lading for outward and homeward cargo are always available for inspection. The Disbursements Book contains the analysed accounts of the agents, including port charges and other outlays, at the various ports of call which may be vouched by reference to the agents' accounts, and supporting vouchers. The principal expenditure accounts, viz. Provisions, Wines, Slops, Stores, Repairs, Reconditioning, etc., should be scrutinized.

The Unclaimed Wage Account should be looked into, and a voucher seen for all payments on this account. The Auditor should also look into the Unclaimed Passage Money Account, returns of insurance premiums where shipping is laid up, and should note how the foreign exchanges are handled. The sufficiency of the Insurance Fund and the investments relating to it should be inquired into, as to which the Auditor may require expert advice. The overhauling of the ship is sometimes a serious item, which may reasonably be spread over a number of voyages.

Shipowners working regular routes will very probably have an arrangement to return a proportion of freight to loyal shippers in the form of deferred rebates. The Auditor should see that the provision for the liability is adequate.

In the case of passenger ships the company may issue orders for return passages available by their own vessels or by those of

other associated lines. It is important to see that there is a reserve sufficient to meet liabilities in this connexion. Considerable passage money usually remains unearned at the end of the accounting period through deferred and return bookings not completed. The Passage Money Register should disclose this.

Debit balances may include considerable sums recoverable from underwriters under general or particular average claims. These can be verified by referring to the company's average adjusters.

Fuel is probably the largest item carried forward from voyage to voyage, and fuel and wages the largest items of expenditure in the Voyage Accounts.

The Auditor should look into and test the system of verifying receipts from sales of wines and tobacco in the case of passenger steamers.

Passage money and number of passengers carried can be verified from the Purser's Waybill and printed list of passengers carried. Rates can be checked with printed schedules.

The apportionment of annual charges such as vessels' insurances, Mutual Club calls, etc., should be tested.

Wages and allowances to officers and crew can be vouched with the voyage portage bills. When the personnel is paid off at the end of a voyage, this is done in the presence of a Board of Trade official whose certified statement can be seen at the Board of Trade if necessary.

Ordinary repairs and cost of undergoing periodical surveys are important items of expenditure on a vessel and a separate Repairs Account is frequently kept by the larger Shipping Companies.

In the case of single ship companies the Articles of Association and Agreements with Managing Owner, Captain, etc., should be perused and notes made of any matter affecting the accounts.

The Auditor should ascertain that no expenditure is added to "Purchase of Ship" Account when the final payment has been made to the vendor.

The Voyage Account should contain all payments made for outfit, disbursements at each port of call, expenses at loading and discharging ports, Captain's emoluments and the Managing Owners' commission. Vouchers for the Outfit Account and the agents' accounts from the various ports should be produced. The vouching is a very important part of the audit, as vouchers may come from several sources, such as the Managing Owners, the Captain, the home agents, the foreign agents, and the underwriters or Insurance Companies. There may also be sundry other receipts. The correctness of the foreign exchange and the calculations should be ascertained.

The Voyage Account should be credited with outward freights, freights received abroad, homewards freights, forfeited wages from the Portage Bill, sales of stores, port charges refunded, etc.

The accounts for the whole period under audit should be examined to ascertain whether the freight of every voyage has been included from the date of the last Account. For this purpose the Auditor should ask for the production of a record of the movements of the vessel, while the rates of freight can be ascertained from the manifests or charter-parties. Demurrage or dispatch money can be verified from the agents' Time Sheets.

The Captain's (or Purser's) Account should be charged with advances to the crew, their wages, cash to himself, and payments on account of his outfit. On the other hand, it should be credited with the Portage Bill, after deduction of forfeited wages, his disbursements, and his remuneration which should be in accordance with his agreement.

By an examination of the policies of insurance and special clauses therein, it can be ascertained if the ships have been fully protected, and that returns for risks not incurred (as when a ship is laid up) and unexpired time have been credited.

No profit should be taken to credit in respect of an uncompleted voyage.

The Auditor should search the Customs Registry Office to ascertain if there is any mortgage on the ship.

When several companies are in one office, the office expenses should be divided on an equitable basis.

All British tramp ships (not regular liners) are entitled to participate in a subsidy to shipping granted by the Government in respect of every foreign voyage made with cargo. The subsidy was first granted in 1935 and has been renewed in 1936, the amount being limited to £2,000,000. It cannot be said whether the subsidy will again be renewed.

In the case of shipping companies registered under the Companies Act, 1929, and owning many ships and having issued debentures with a floating charge on the assets of the company, it is necessary to register these debentures at the port of registry, otherwise prior lien on the vessels is sacrified. It is sometimes the *practice to register the whole amount against each vessel.*

Each ship must be registered separately at the port of registry.

The shares in a ship are always divided into sixty-fourths. Nowadays, however, it is most usual for 64/64ths to be owned by an individual or a company.

Single ship companies must be registered under the Companies Act like any other company.

To register a new ship it is necessary to produce to the Registrar at the port of intended registry, evidence of title to the vessel,

viz. Builder's Certificate and any intermediate bills of sale proving a sequence of title. Application to the Board of Trade is then made on a form provided by the Registrar for permission to call the vessel by the name chosen. In the case of a new ship application must then be made to the Board of Trade Surveyors to measure the ship. The Surveyor's Certificate will be forwarded to the Registrar when completed. When this is received and title proved a Declaration of Ownership will be required. This is made out on a special form and must be attested by the Registrar of Shipping. Registration fees are payable in accordance with gross tonnage of the vessel.

As mentioned above the shares in all cases are sixty-fourths. In the case of a single owner 64/64ths are in his name.

A ship may be owned by an individual or by bodies corporate or by joint owners. In the last-mentioned case one person must be appointed as managing owner. A firm which is not a limited company cannot itself be registered as owner of a ship, but the individual partners may be registered as joint owners appointing a managing owner.

The owner of one sixty-fourth share can transfer it to a limited company, but it would not avoid the liability attaching to such share. The liability is limited by statute to £8 per gross register ton of the vessel, for damage to property, and £15 for loss of life.

The Register of a ship is not signed by buyer or seller but by the Registrar. Transfers of shares in a ship are made by bill of sale.

A mortgage not registered at the port of registry would not be invalid but loses its priority of claim if not so recorded.

SOLICITORS' ACCOUNTS

Balance Sheet. The amount included as costs should distinguish between costs delivered, but not paid, and costs not delivered (as shown by the draft bills) and estimates of costs outstanding. Many solicitors only bring into account costs delivered and paid from year to year, a sound practice from a financial point of view. In the case, however, of changes in a partnership, this practice would not always work out fairly, and adjustments are necessary. Moneys held on account of clients should be shown separately and kept in a separate Banking Account. Any fees due to counsel, as shown by the bills of costs, should be brought in as a liability. Premiums received on account of articled clerks should be apportioned, and a proportionate amount carried forward.

Transactions. The Cash Book should have two banking columns distinguishing between clients' moneys and solicitor's moneys, and the Auditor should see that they are properly distinguished.

Disbursements appear in the Cash Book, Petty Cash Book, and Disbursements Journal. To facilitate the audit, these books should be ruled on the columnar principle so as to distinguish disbursements on account of clients from the solicitor's own expenses. Disbursements should be carefully scrutinized, and the solicitor asked to examine them personally, as it is here irregularities may occur.

The total disbursements chargeable to clients should be agreed with the total disbursements charged to clients in the Clients' Ledger, as shown by the list of balances extracted at the close of the year, costs and disbursements being entered in separate columns in the Ledger.

A Register of Bills delivered should be kept, showing which have been paid, and the solicitor should be asked to go through this periodically.

By reference to the solicitor's diary, the Auditor may satisfy himself that all matters are being duly charged out in the books and accounted for.

The Auditor should be familiar with the Solicitors Act, 1933, and the Rules made by the Council of the Law Society under Section 1 of the Act. These rules are known as the "Solicitors Accounts Rules, 1935."

STOCKBROKERS

Balance Sheet. The Balance Sheet is a comparatively simple one, consisting of balances due to or by jobbers and clients, balances at bankers, loans on security, securities on hand (which are brought in at the market price at date of balancing), also names receivable and names payable, representing sums due on stocks to be delivered by or delivered to brokers, and of dividends to be collected or paid over.

Transactions. To those familiar with Stock Exchange practice, the checking of the whole of the transactions presents no difficulty, provided the books are written up in reasonable detail, and the Auditor has not to "dig out" necessary information from pocket books kept in a somewhat cryptic fashion. The book-keeping of some stockbrokers is, however, congested, ill-devised, and inadequate, reference folios are omitted in the Ledgers, necessary details as to receipts and payments for stocks and shares omitted from the Cash Book, and no clear record kept of "names" and of dividends to be paid or claimed. In "boom" times, stockbrokers' accounts of this class may fall into a certain amount of confusion. It is on such occasions that the services of professional Accountants are requisitioned to agree the books and clear up discrepancies, for there is but little auditing in the restricted sense of auditing in stockbrokers' Balance Sheets.

To ensure the absolute accuracy of the books, the following work is necessary—

1. Call down balances from previous account.
2. Call Contango Journal to Clients' Ledgers at opening and close of the account.
3. Call debit side of Bought Journal to Clients' Ledgers.
4. Call credit side of Sold Journal to Clients' Ledgers.
5. Call Cash Book to Clients' Ledgers.
6. Call Sundries Journal to Clients' Ledgers.
7. Call Dividend Journal to Clients' Ledgers.
8. Call Rights Journal to Clients' Ledgers.

STOCKJOBBERS

The Balance Sheet comprises moneys owing to and by brokers, and shares "open" where the jobber has not "evened" his book; also securities on hand, dividends to be collected or paid over. The checking of the transactions presents no difficulty in normal cases where the books are kept on an adequate system.

It is beyond the scope of this volume to describe Stock Exchange practice and book-keeping in detail, and an expert knowledge of both is essential to agreeing the books and raising correct accounts, or auditing them effectively.

The jobber is the market. He does not come into touch with the public at all, but deals only with brokers, covering the bargains he makes by, sooner or later, re-buying or re-selling. When called upon he makes two prices, the lower that at which he is ready to buy, the higher that at which he will sell.

He should keep the following books—

1. Jobbing Book.
2. Checking Book.
3. Journal.
4. Contango Book.

4A. Contango Journal.

5. List Book.
6. Names Receivable.
7. Names Payable.
8. Cash Book.
9. Jobbers Ledger.
10. Impersonal Ledger.
11. Private Ledger.
12. Stock "Take and Deliver" Ledger.

The following checking should be done—

1 Call balances brought over from previous account in Jobbers Ledgers, if any, and check any differences adjusted in subsequent accounts.

2. Call Contango Journal to Jobbers' Ledger at opening and close of Account.
3. Call credit side of Bought Journal to Jobbers' Ledger.
4. Call debit side of Sold Journal to Jobbers' Ledger.
5. Call Cash Book to Jobbers' Ledger.
6. Call Sundries Journal to Jobbers' Ledgers.
7. Call Rights Journal to Jobbers' Ledger and compare Journal with "Rights" list (i.e. dividend list issued officially).
8. Call Dividend Journal to Jobbers' Ledgers and examine dividend list and see dividends have been duly debited or credited.

TEA COMPANIES

The outstanding feature is the provision to be made for replacements of buildings and machinery. It is also prudent, though not legally compulsory, to build up a reserve in respect of the properties some of which may under certain conditions go out of cultivation. The detail work does not require any special comment.

THEATRES, MUSIC HALLS, ETC.

Balance Sheet. The special items are scenery, wardrobe materials in store and in use, furniture and fittings, including seating accommodation, electric light fittings, etc., printed material, posters, etc. Some of the scenery is stock scenery, which may be depreciated slowly. Scenery for special productions not likely to be used again without substantial alterations should be written off quickly out of the earnings of the production. The Auditor should see that the wardrobe purchases are duly spread over new productions, renewals, running productions and tours, according to the facts, and are written down quickly. He should also see that all liabilities for advertising, including posters, etc., are brought into account.

Transactions. The Salaries Book may be compared with the Attendance Book kept at the stage door. Overtime charged should be authorized by the stage manager.

In a well-organized theatre or hall there is a complete check upon all receipts based upon counterfoil tickets in triplicate for reserved seats, roll tickets or check machines for unreserved seats, and the counters return. The receipts may be checked by reference to the House Receipts Book which is compiled from the house, bar, and programme receipts. Programme receipts are verified by the number of programmes printed and given out, the programmes being fastened in a special way, so that they cannot be sold over again.

For cloak room fees, Counterfoil Receipt Books should be available. Receipts from the bar are vouched by returns of sales

made by the bar attendants (controlled by the bar manager), stock also being taken at intervals by a gauger as an additional check.

Advance bookings should be reserved for, and the amount reserved agreed with the amount received in advance, as shown by the House Receipts book. This figure can be verified by checking the tickets torn out of the Ticket Books in the box office at the date to which the audit relates. The Libraries Accounts should be agreed with the Libraries Book. The Tour Manager's Accounts, as certified, should be agreed with the Tour Book.

TRUST AND FINANCE COMPANIES

The Auditor should ascertain that the amounts carried to the credit of the Profit and Loss Account have been definitely earned and are not subject to any possible deductions on valuation, or require a reserve to be made. When the profits are represented by shares in other companies, either as the result of promoting or of underwriting, the Auditor should recommend that such profits be treated in a separate Profit and Loss Account, and that only the profits earned on realization of such shares be carried to the General Profit and Loss Account, which shows the profit available for dividend.

He should ascertain whether each investment (whether debentures or shares) and loan has yielded interest or dividend, as the investments of trust and finance companies are sometimes non-dividend paying. In the case of investments or loans not producing income, reasons should be required. Accrued interest on the debentures of unquestionable value may be taken credit for.

Especial care must be taken when considering the value taken credit for in the Balance Sheet in respect of the Investments. When a finance company promotes mines there is frequently no quotation for the shares of the new ventures, and when there is a quotation it may apply only to a small block of shares.

Brokers' Notes should be compared with the prices stated to have been paid for stock or received on account of stock sold, and also for the purpose of ascertaining that dividends and interest accrued on stock has been accounted for.

Should there be any liability on the shares held as investments, the fact must be shown on the face of the Balance Sheet, or else referred to in the Auditor's Certificate.

The essential distinction between trust companies and finance companies should be borne in mind. In the case of a trust company the investments are of the nature of fixed assets purchased for the purpose of earning income. The investments may be stated at cost in the Balance Sheet even though this may exceed the market value at the date of the Balance Sheet; prudence, however.

indicates the creation by degrees of a reserve to meet depreciation. In any case a note should appear on the Balance Sheet giving the market value at the date of the Balance Sheet. Profits on sales of investments should be utilized to write down the cost of remaining investments; it is not necessary to write off losses on sales to Profit and Loss Account.

The investments of a finance company are in the nature of stock-in-trade and should be brought into the account at the market value at the date of the accounts. It is usual to bring to credit of the Profit and Loss Account only realized profits on sales, and items of an income character such as dividends, underwriting commission, etc. Profits arising from increases in the market value of investments unsold should be held in suspense until realized. Frequently a special account is opened for this purpose.

It is usual for the articles of trust companies (as opposed to finance companies) to provide that profits on sales of investments shall not be distributed in dividend, the amounts distributable being limited to income of the class which would be paid to a life tenant. This would include bonus shares received by way of distribution of profit of a company in which the trust company held an investment, if such shares are sold.

WATER COMPANIES

The accounts of these companies may, with advantage, be raised in the same form as gas and electric lighting companies, as the questions arising are of a similar nature. The charge for water is either by meter, or based on rateable value, no charge being made in respect of empty houses, and the testing of the receipts is not, therefore, a complicated matter. Water rates are chargeable in advance, and should, therefore, be apportioned from year to year. The Auditor may test the figures by a comparison of the aggregate totals from year to year, looking into the cause of any striking variation.

WINE MERCHANTS

Balance Sheets. A special item is the stock, which, unlike most stocks, usually improves with age. The stock consists of stock in bond (on which duty has not been paid), stock in bins, in cases (as shipped), and in bulk (in vats or casks). For each of these classes of stock there should be a special Stock Book with which the particulars of the Stock Sheets may be compared, allowing for ullages and shorts (breakages, etc.), which should be written off in the Stock Books. In some cases it is the practice to add interest at 5 per cent to the stock every year, provided the wine will bear it, that is to say, is considered to have improved sufficiently. In this way interest is treated as part of the cost. Unless

the stock is increasing in quantity from year to year the effect of this addition will average out over a period of years, and is not unreasonable, but the sounder practice is that interest be added for the purpose of arriving at cost and fixing selling prices, but only be brought into account when the wine is sold. If the stock is increasing, and the profits, including interest, are divided, the financial position becomes unsound, unless capital is brought in equivalent to the interest added to the stock. Where interest is added, the facts should be set out on the face of the accounts.

Transactions. Discounts and allowances should be carefully scrutinized. Where clubs, hotels, etc., are supplied on sale or return, see that the supplies are not treated as sales until actually sold, but are brought into stock at cost. See also that jars and cases charged out to customers are not also included in the stock. Where there is a well-kept Cellar Book, the quantities received into and passing out of the cellar, returns, etc., may be effectively traced through the books.

CHAPTER XVIII

SHARE CAPITAL

THE amount of the share capital of a company is set out in the Memorandum and Articles of Association, as for example—

The capital of the company is £500,000 divided into 500,000 shares of £1 each, with power to divide the shares in the capital for the time being into several classes, and to attach thereto respectively any preferential, deferred, qualified or special rights, privileges or conditions.

The share capital may consist of any of the following classes—

Preference Shares (Non-cumulative).

Preference Shares (Cumulative).

Preference Shares (Cumulative or non-cumulative and Participating).

Redeemable Preference Shares (cumulative, non-cumulative or participating).

Ordinary Shares.

Deferred Shares (or Founders' Shares).

Particulars of the classes of shares are contained in the Memorandum and Articles of Association, and may be varied from time to time by special resolution or by order of the Court under a scheme of reconstruction or for reduction of capital. As mentioned in Chapter III, page 23, the particulars and any variations thereof should be recorded in the Auditor's permanent note-book. In the case of a reconstruction the Auditor should satisfy himself that the new capital is in accordance with the agreements entered into relating to the reconstruction. If the alteration has been authorized by an Order of Court, an office copy of the Order should be produced to the Auditor.

Non-cumulative Preference Shares entitle their holders to a preferential dividend, at a stipulated rate, out of the profits of the year only, before a dividend can be paid on other shares. If no profits are earned no dividend is payable.

Cumulative Preference Shares entitle their holders to payment of the preferential dividend, at the stipulated rate, out of the profits of the year, but in the event of the profits of any one year not being sufficient to provide for the stipulated dividend, the arrears must be paid out of the profits of future years, and the preference dividends paid up to date, before a dividend can be paid on other shares. Unless the contrary intention is expressed in defining the rights of preference shareholders, shares entitling their holders to a preference dividend at a given rate are *prima facie* cumulative.

Participating Preference Shares entitle their holders not only to a fixed dividend, but to an additional dividend after the ordinary shareholders have received a dividend at a stipulated rate.

If, as is usual, it rests with the Directors to declare the dividend on the preference shares, the dividend does not become payable and therefore not a liability of the company until it has been declared. Unless, therefore, there is a contrary provision in the Articles, arrears of undeclared preference dividends may not be a liability in a liquidation of the company and are not payable out of surplus assets.

Preference shares are not entitled to priority in a return of capital in a winding up unless the Articles so provide. In the absence of any contrary provision in the Articles, preference shares having this right of priority share rateably with ordinary shareholders in any surplus after the ordinary shareholders have been repaid.—*Re Espuela Land and Cattle Co.*, [1909] 2 Ch. 187; 78 L.J. Ch. 729.

SURRENDER OF SHARES

Surrender of shares is in fact a reduction of capital and, to avoid any uncertainty, it is advisable to have the sanction of the Court for any arrangement for surrender. The Auditor is only concerned to see that the terms of surrender are duly given effect to in the books and accounts.

REDUCTION OF CAPITAL

Provisions as to reduction of capital are set out in Sections 55 to 60 of the Companies Act, 1929. The Auditor's duty is to see that the terms as set out under the arrangement approved by the Court are duly given effect to in the books and accounts.

CASES

A company's capital consisted of 5 per cent cumulative preference shares and ordinary shares, the preference shares having priority as to both capital and dividend, and the preferential dividend being payable before any profits could be carried to reserve.

The Articles provided that no dividend should be payable except out of profits, and that, in the event of the company being wound up, the surplus divisible assets for the time being remaining "after paying the liabilities of the company" should be applied first in repaying the preference capital, and "secondly in paying the arrears (if any) of the 5 per cent preferential dividends thereon to the commencement of the winding up." The remainder of the surplus assets was to belong to the ordinary shareholders.

No dividends were ever declared, but the profits accumulated until the company was wound up.—

Held, that the preference shareholders were entitled to their arrears of preferential dividends, though not declared, but only to the extent of the accumulated profits.—*Re W. J. Hall & Co., Ltd.*, [1909] 1 Ch. 521, but distinguish *re Crichton's Oil Co.*, [1901] 2 Ch. 184; [1902] 2 Ch. 86, in which it was held that where the shareholders were only entitled to dividends when declared by the directors, the shareholders, in the event of liquidation, could only claim for dividends so declared.

Where a company issues preference shares carrying dividend at 10 per cent per annum, payable half-yearly, and with no words restricting the holders of such shares to the profits of the current year, the deficiency in the profits of any one year to pay the 10 per cent in full was, as between the preference and ordinary shareholder, to be made good out of subsequent profits.—*Foster* v. *Coles and M. B. Foster & Sons, Ltd.*, [1906] W.N. 107.

In cases not within Sections 13 and 14 of the Companies Clauses Act, 1863, it has been held that preference shareholders are entitled to have arrears of interest made up out of the profits of subsequent years.—*Henry* v. *Great Northern Railway Co.* (1857), 1 De G. & J. 606; *Corry* v. *Londonderry, etc., Railway Co.* (1860), 29 Beav. 263; *Matthews* v. *Great Northern Railway Co.* (1860), 28 L.J. Ch. 375.

Preference shareholders who have allowed the surplus profits of one year to be applied in payment of ordinary shareholders, instead of in payment of arrears due to them, are not prevented from claiming such arrears against the profits of future years.—*Matthews* v. *Great Northern Railway Co.* (1860), 28 L.J. Ch. 375.

When the Memorandum of Association of a company incorporated under the Companies Act, 1862, stated that a portion of the shares were to have a right of receiving a dividend by preference to the other shares, resolutions passed by the company altering the priorities and payments of the net revenue as between the preference and ordinary shareholders were held to be not valid, and that no resolution of the company, special or otherwise, could alter the contract made between the company and all the shareholders, and that the revenue of the company available for dividend must be applied in the manner originally prescribed by the Memorandum of Association.—*Ashbury* v. *Watson* (1885), 28 Ch.D. 56 and 30 Ch.D. 376.

If the yearly profits are divisible among the holders of the ordinary shares, subject to the half-yearly dividend to the holders of the preference shares, the preference dividend is not cumulative.—*Adair* v. *Old Bushmills Distillery Co. Ltd.*, [1908] W.N. 24.

REDEEMABLE PREFERENCE SHARES

The issue of this class of shares was authorized for the first time by Section 46 of the Companies Act, 1929. Subject to the provisions of that Section a company limited by shares may, if so authorized by its Articles, issue preference shares which are, or at the option of the company are to be liable, to be redeemed: Provided that—

(*a*) no such shares shall be redeemed except out of profits of the company which would otherwise be available for dividend or out of the proceeds of a fresh issue of shares made for the purposes of the redemption;

(*b*) no such shares shall be redeemed unless they are fully paid;

(*c*) where any such shares are redeemed otherwise than out of the proceeds of a fresh issue, there shall out of profits which would otherwise have been available for dividend be transferred to a reserve fund, to be called "the capital redemption reserve fund," a sum equal to the amount applied in redeeming the shares, and the provisions of this Act relating to the reduction of the share capital of a company shall, except as provided in this Section, apply as if the capital redemption reserve fund were paid-up share capital of the company;

(*d*) where any such shares are redeemed out of the proceeds of a fresh issue, the premium, if any, payable on redemption, must have been provided for out of the profits of the company before the shares are redeemed.

There shall be included in every Balance Sheet of a company which has issued redeemable preference shares a statement specifying what part of the issued capital of the company consists of such shares and the date on or before which those shares are, or are to be liable, to be redeemed.

Subject to the provisions of this Section, the redemption of preference shares thereunder may be effected on such terms and in such manner as may be provided by the Articles of the company.

Where a company has redeemed or is about to redeem any preference shares, it shall have power to issue shares up to the nominal amount of the shares redeemed or to be redeemed as if those shares had never been issued, and there will be no liability for stamp duty on the issue if redemption of the old shares takes place within a month after the issue of the new shares, or if it takes place before such new issue.

Where new shares have been issued in the circumstances outlined in the preceding paragraph the capital reserve fund may be applied, up to an amount equal to the nominal amount of the shares so issued, in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares.

ORDINARY SHARES

The holders of ordinary shares are entitled to the surplus profits subject to the payment of dividends to holders of shares giving preferential rights. Sometimes ordinary shares are divided into preferred and deferred ordinary shares, in which case the preferred are in the same position as preference shares in relation

to dividend, being entitled to a fixed rate of dividend in priority to the deferred shares, which are entitled to the surplus profits.

DEFERRED OR FOUNDERS' SHARES

The holders of these shares are entitled to dividends after holders of other shares have received a prescribed dividend, and are as a rule entitled to the whole or a proportion of the remaining profits. Usually these shares are issued as fully paid to founders or promoters of a company in consideration of the services which they have rendered.

SHARES OF NO PAR VALUE

These cannot be issued in this country though they are common in the United States of America. It is not, therefore, proposed to consider their merits or demerits in this volume.

SHARES ISSUED AT A DISCOUNT

Companies are now empowered by Section 47 of the Companies Act, 1929, to issue at a discount shares of a class already issued. Provided that—

(*a*) The issue of the shares at a discount must be authorized by resolution passed in general meeting and must be sanctioned by the Court.

(*b*) The resolution must specify the maximum rate of discount at which the shares are to be issued.

(*c*) Not less than one year must, at the date of issue, have elapsed since the date on which the company was entitled to commence business.

(*d*) The shares to be issued at a discount must be issued within one month after the date on which the issue is sanctioned by the Court or such extended time as the Court may allow.

Every prospectus relating to the issue of the shares and every Balance Sheet issued subsequently to the issue of the shares must contain particulars of the discount allowed on the issue of the shares, or of so much of the discount as has not been written off at the date of the issue of the Balance Sheet or Prospectus.

PURCHASE BY COMPANY OF ITS OWN SHARES

A company may not, either directly or indirectly, or by means of a loan, guarantee, provision of security or otherwise, give any financial assistance to a person to purchase shares in the company. This does not apply to loans under a scheme for the purchase by trustees for the benefit of employees of the company or to enable employees to purchase fully paid shares.

The aggregate amount of loans made in accordance with these

authorized exceptions must be shown separately in the Balance Sheet.

CASES

There is nothing in the Companies Acts expressly or by necessary implication prohibiting a limited company from mortgaging its unpaid capital; consequently, where power to mortgage future or unpaid-up capital is given by the Memorandum or Articles of Association, a mortgage of such is valid.—*Re Pyle Works* (1890), 44 Ch D. 534. This decision was approved by the Judicial Committee of the Privy Council on an appeal from the Supreme Court of New South Wales, the Companies Act being for this purpose indentical with the English Act of 1862, on the 6th March, 1895.—*Newton* v. *Debenture-holders, etc., of Anglo-Australian, etc., Company*, [1895] A.C. 244. The Companies Act, 1929, Section 79, implies that uncalled share capital can be mortgaged or charged.

A company has no power to create any charge on that portion of its capital which, in accordance with a resolution passed under this Section, can only be called up "in the event of and for the purposes of the company being wound up."—*Re Mayfair Property Co., Bartlett* v. *Mayfair Property Co.*, [1898] 2 Ch. 28; *Re Irish Club Co., Ltd.*, [1906] W.N. 127.

The capital of a limited company may not be diminished by a surrender to it by shareholders of partly-paid shares, as such is a transaction of purchase and sale, the company in effect purchasing the shares at the price of discharging the shareholders from their liability to calls, and such a transaction is bad under the decision in *Trevor* v. *Whitworth* (1888), 12 App. Cas. 409.—*Bellerby* v. *Rowland & Marwood's Steamship Co., Ltd.*, [1901] 2 Ch. 265.

In a case it appeared that the directors of the company had each surrendered shares to the company in order to write off an extraordinary loss which had arisen on the sale of one of the company's ships. Some years later, the company having made profits, it was proposed that special remuneration should be paid to the Directors by issuing to them the surrendered shares. The arrangement was contrary to the decision in *Trevor* v. *Whitworth* (12 App. Cas. 409) and the original surrender was illegal, so that the question of re-issuing the shares did not arise.—*Bellerby* v. *Rowland & Marwood's Steamship Co., Ltd.*, [1901] 2 Ch. 265.

A surrender of shares to a limited company, not involving any reduction of capital and not amounting to a purchase of its own shares by the company, is not necessarily *ultra vires*.

In 1896, pursuant to Articles of Association and special resolution, the holders of 6 per cent fully-paid preference shares surrendered them to the company in exchange for fully-paid 5 per cent preference shares, and a contract in writing was duly filed

with the Registrar of Companies, pursuant to Section 25 of the Companies Act, 1867. The surrendered shares were not cancelled, but were subject to be reissued by the company.

Held, that the surrender not involving any reduction of capital was valid; that the transaction did not amount to a purchase by the company of its own shares; and that the new shares issued in exchange were fully paid up.—*Rowell* v. *John Rowell & Sons Ltd.*, [1912] 2 Ch. 610.

The power to reduce capital must be conferred by the Articles, and not by the Memorandum.—*Re Dexine Rubber Co.*, [1903] W.N. 82.

Payment on shares made by a fictitious proceeding under which a company never really receives the amount payable on the shares at all is invalid.—*Aspinall's Case, Re The Eupion Fuel and Gas Co.* (1877), 36 L.T. 362; *Hay's Case, re Canadian Oilworks Corporation* (1875), 10 Ch.App. 593.

A company governed by the Companies Clauses Consolidation Act, 1845, and the Acts amending it, may issue fully paid-up original stock at a discount, and for payment either in cash, for land or labour, or other consideration, subject to the liability of the Directors for issuing the stock below its value without necessity.

Such companies may also issue debentures or debenture stock at a discount, if authorized to borrow money or raise money by mortgages or debentures.—*Webb* v. *Shropshire Railways Co.*, [1893] 3 Ch. 307.

A company governed by the same Acts may issue fully paid-up original shares at a sum less than their nominal amount in the same manner as new shares can under the authority of those Acts be issued.—*Statham* v. *Brighton Marine Palace and Pier Co.*, [1899] 1 Ch. 199.

As mentioned previously in this chapter, the Companies Act, 1929, Section 47, empowers companies, for the first time, to issue shares at a discount provided that they are of a class already issued.

The subscribers of the Memorandum of a company shall be deemed to have agreed to become members of the company, and on its registration shall be entered as members in its Register of Members.

The agreement is satisfied by the allotment of a larger number of shares on a formal letter of application.—*Gilman's Case, re Crookes Mining and Smelting Co.* (1886), 31 Ch.D. 420.

Every other person who agrees to become a member of a company, and whose name is entered in its Register of Members, shall be a member of the company.

The Auditor must satisfy himself that all the shares applied for on the Memorandum of Association are included in the capital

in the Balance Sheet, whether they have or have not been allotted, and if not paid for the amount unpaid, so far as it is called up on the other shares of like class, must be treated as "calls in arrear."

The register may consist of several books, which, by reference from one to the other, will supply all the information required.—*Weikersheim's Case re Land Credit Co. of Ireland* (1873), 8 Ch. App. 831, 836.

A company having a share capital, whose objects comprise the transaction of business in a Colony, may, if so authorized by its Articles of Association, cause to be kept in any Colony in which it transacts business a branch Register of Members resident in that Colony (Section 34-36).

A contract between a company and one of its shareholders that calls shall be set off against goods to be supplied by the shareholder instead of being paid for in money is *ultra vires*.—*Pellatt's Case re Richmond Hill Hotel Co.* (1867), 2 Ch.App. 527.

"Every year" means a year from 1st January to 31st December.—*Gibson* v. *Barton* (1875), L.R. 10 Q.B. 329; *Edmonds* v. *Foster* (1876), 33 L.T. 690.

The word "interest" does not mean "dividend." Interest upon moneys paid in advance is a legal debt, payable out of any assets of the company, including its capital.—*Lock* v. *Queensland Investment and Land Mortgage Company, Ltd.*, [1896] A.C. 461.

Forfeited shares may be re-issued as paid up to an amount not exceeding the amount paid by the previous holder, and may be so re-issued in consideration of a sum less than the sum credited as paid on them.—*Morrison* v. *Trustees, Executors, and Securities Insurance Corporation Ltd.*, [1898] W.N. 154.

The books containing these minutes are known as "Minute Books." In large companies it is the practice to keep separate "Minute Books" for meetings of the Directors, for meetings of committees of the Directors, and for meetings of shareholders respectively. These "Minute Books" are, it is conceived, open to the inspection of the Auditor should he, in the performance of his duties, consider such an inspection desirable.

A clause giving a right of inspection of "the books wherein the proceedings of the company are recorded" does not give a shareholder the right to inspect the books of minutes of the proceedings of the Directors.—*R.* v. *Mariquita Company* (1859), 1 E. & E. 289.

The bearer of a share warrant shall not be deemed to be the holder of the shares specified in the warrant for the purposes of director's qualification (Companies Act 1929, Section 141 (2)).

A loose-leaf record does not constitute a book within the meaning of Section 120 of the Companies Act, 1929. The question whether a Minute Book in the form of a loose-leaf record is a book within the meaning of the Act was raised in a case which was

summarized in *The Accountant* of 19th October, 1935, page 547. Bennett, J., said that the thing which Mr. Morton called a Minute Book consisted of a number of loose leaves fastened together between two covers in such a physical condition that at any moment anybody who pleased to do so could take out any number of leaves and substitute any number of other leaves. This was a thing which people, if they were minded to be dishonest, could readily and easily tamper with without anybody being able to see that it had been tampered with. What he had to decide was whether this thing was a book within the meaning of Section 120 of the Companies Act, 1929. So far as he knew there was no other authority on the question, but he would hold that it was not a book as he thought it most undesirable that anything that could be added to or taken away from at any moment without anyone being the wiser should be put in as evidence under the Section. On that ground he found that what was tendered was not a book within Section 120 and he rejected the evidence.

Having regard to the increasing use of loose-leaf records and the fact that many banks have substituted loose-leaf records for Pass-books, it seems likely that this decision will in due course be the subject of legislation.

ROUTINE WORK OF AUDIT OF SHARE CAPITAL

At the first audit the issue of the share capital should be checked by reference to the Application and Allotment Sheets, which should be initialed or signed for identification by the chairman of the Board of Directors, and the minute of the Board authorizing the allotment should be seen. The Application and Allotment Sheets should be compared with the Application Letters and counterfoils of the Allotment Letters, or with the Allotment Letters themselves if they have been surrendered in exchange for Share Certificates. The moneys received in respect of the shares should be traced to the company's Banking Account. If there be calls in arrear the amount should appear as a deduction from the share capital on the face of the Balance Sheet. A list of the arrears as shown in the Share Ledgers should be made and the list agreed with the Ledger Balance "Calls in Arrear." The attention of the Directors should be drawn to the arrears, and correspondence with the shareholders who are in arrear inspected. As regards calls on shares, see the minute making the call, agree the amount received with the amount due on the shares in the Share Register, trace the moneys received to the bank, and report as to arrears as before. A separate Banking Account should be opened in respect of moneys received on application and allotment and for each call. Any subsequent issues of shares should be checked in the same way.

The Auditor should see that the total number of shares on the Register agrees with the Share Capital Account, and that the total capital issued does not exceed the authorized capital as originally fixed by the Memorandum of Association, or as subsequently increased. Each class of shares should have a separate account in the Ledger, and the balances be agreed with the aggregate of the balances appearing in the respective Share Registers.

The Auditor should see what conditions or rights attach to the various classes of shares, and that these conditions or rights have been duly complied with. The transfer of shares may be compared with the Transfer Register, the register called to the Share Register, the counterfoils of issued certificates examined, and cancelled certificates produced. This, however, is not so much a question of accounting as of record. The checking of the transactions is usually a matter of special arrangement, the checking being done by the Auditors before each board meeting and a report made that the certificates to be signed are in order.

A record should be kept giving details of the certificates cancelled and the new certificates issued with an agreement of the respective totals. (See Chapter XX, as to verification of the transfer of shares, share certificates, etc.)

CHAPTER XIX

GENERAL RESERVES, SPECIFIC RESERVES, SINKING FUNDS AND INTERNAL RESERVES

RESERVES may be general or specific, and are amounts set aside, as a rule out of profits, for a general or a specific purpose. A specific reserve is set aside to provide for some anticipated or possible loss in the value of an asset by way of exceptional depreciation or otherwise; to redeem debentures; to create a Sinking Fund; provide for some exceptional liability, or for some similar object. A general reserve is set aside to strengthen the liquid position of the business by retaining, in reserve, profits which might otherwise be distributed in cash. In this way resources are provided to meet contingencies. A general reserve differs only in name from the "carry forward," as the balance remaining at the credit of Profit and Loss Account (after deducting dividends) is commonly called. The transfer of part of the profits to general reserve has the effect of setting aside a sum which thereupon ceases to be regarded as profits available for distribution under ordinary circumstances.

SPECIFIC RESERVES

In the case of a specific reserve the amount to be set aside cannot be definitely ascertained. It is not, therefore, desirable to deal with the question by writing down the asset concerned or by setting up a fixed liability. The position may vary in following years, and an increase or a decrease in the amount of the reserve may be necessary or advisable. Reserves against specific assets can best be shown as deductions from those assets in the Balance Sheet. If they are shown on the liabilities side, it is desirable that the amounts be separately stated and so described that their nature is apparent. It is important, since these reserves are for a specified purpose and not, therefore, free for distribution, that they should not be confused with a General Reserve which as already stated represents what are undistributed profits.

Examples of specific reserves are reserves for possible obsolescence of plant and machinery, dilapidations of buildings, expiry of leases, doubtful debts, possible shrinkage in the value of investments, claims in dispute, or liabilities which may arise under uncompleted contracts. In any of these cases a definite loss may eventually arise, and if profits are set aside by way of reserve to meet such losses, the position can be met without difficulty.

The Auditor's views in relation to reserves are determined by his examination of the position disclosed by the books. He cannot insist on the creation of reserves which he may think are necessary. His duty, if he is dissatisfied, is to report his view to the shareholders who are in this way given the opportunity of determining whether they will accept the views of the Directors or those of the Auditor.

GENERAL RESERVES

General reserves are set aside to strengthen the liquid position of a business and to provide for any eventuality which may possibly arise. Experience shows that any business, sooner or later, may have to face some unforeseen contingency. It is, therefore, sound finance to withhold part of the profits from distribution and set them aside as a general reserve.

The question of dealing with the amount so set aside is one of policy. It may be required in the business for use as working capital, to finance the development or expansion of the business, for which additional share capital would otherwise be required. If it is not likely to be required in the business it may be invested and earn interest, taking the chance of a gain or loss on realization. The invested reserve has the advantage of being in a liquid form readily realizable to meet an emergency. It is usual to describe a reserve when invested as a "Reserve Fund." That in fact is the real meaning of "Reserve Fund." The term is frequently loosely used as meaning any reserve, whether invested outside the business or not, but the facts should be apparent from the Balance Sheet.

SINKING FUNDS

A "Sinking Fund" is a form of specific reserve set aside for the redemption of a debt or the replacement of a wasting or depreciating asset. It is created by charging the requisite amount to the debit of Income or Profit and Loss Account. A corresponding amount of the company's funds is invested outside the business, the investments so made being specific assets representing the Fund. As the amount is written off to Profit and Loss Account, the correct way to bring the amount into the Balance Sheet is to raise two accounts, one on the Assets side of the Balance Sheet setting out the investments, and one on the other side called the "Sinking Fund" which corresponds with these investments. The interest earned on the investments is usually added to the Sinking Fund unless the conditions attaching to the Sinking Fund provide otherwise. The Sinking Fund should be used only for the purpose for which it has been raised, unless the necessity for it lapses.

The effect of the setting aside of a Sinking Fund is to invest profits year by year. As a result when the Sinking Fund has matured, there will be a sum at the credit of Sinking Fund Account which is in reality accumulated income.

If the fund is for the purpose of replacing an asset, no other provision will probably have been made for the depreciation of the asset. The procedure on the realization of the Sinking Fund will therefore be to write off the expired asset by a transfer from the Sinking Fund and to use the proceeds, in cash, of the Sinking Fund for replacement of the expired asset, or for investment or as may be dictated by circumstances. If the Fund is for the extinction of a liability, such as a debenture debt, the Sinking Fund investments will be used to pay off the liability and the balance on the Sinking Fund Account itself will become a free reserve, having been raised out of profits year by year.

As an alternative to the purchase of investments, an endowment policy may be taken out payable on a given date for the amount which will ultimately be required. In this case the definite amount assured is available on the due date and no risk of capital depreciation will arise if the insurance company selected is one of repute. The risk of depreciation in investments is a disadvantage of the investment method which cannot be ignored. On the other hand investments may appreciate. The manner of setting aside is, however, a question of policy. The Auditor is only concerned to see that the facts are correctly set out.

If a policy is taken out—

(*a*) Profit and Loss Account should be debited with the amount of the annual premium.

(*b*) A Sinking Fund Policy Account should be raised on the credit side and a Sinking Fund Account on the debit side of the Balance Sheet.

In the earlier years the Sinking Fund policy will not be equal in value to the Sinking Fund Account, but the yearly addition of interest to the premiums by the insurance company gradually increases the value of the policy representing the Sinking Fund. It is not usual to credit the accumulating interest to Profit and Loss Account.

At maturity the value of the policy will therefore exceed the total of the sinking fund. The difference should be credited to the Sinking Fund Account, and the Policy Account will be extinguished by the receipt of the cash due on maturity. The cash, which represents saving out of income, will then be in the coffers of the business and available for the purpose for which it is required.

The interest *may* be added from year to year to the Sinking

Fund premiums on the one side of the Balance Sheet and to the Fund on the other side. If this be done an allowance must be made for the expenses chargeable in respect of the policy which will usually amount to one year's premium.

SECRET RESERVES

Reserves of another character known as "Secret Reserves" or "Internal Reserves" may sometimes be created by writing down stocks or other assets, or over-estimating liabilities not capable of a precise computation. As their name suggests, these reserves are not shown on the face of the Balance Sheet. Reserves of this type were more common in the days when limited companies were few in number, and business was mainly in the hands of private traders. As reserves of a precautionary nature making for financial stability they are not objectionable, where made in good faith.

The whole question of secret reserves was considered very fully in the case of *R.* v. *Lord Kylsant and Morland* (better known as the Royal Mail case) in 1931. Reports of the case should be studied carefully, but the following extract from the Judge's summing up may appropriately be quoted:

> We have heard a great deal about the keeping of secret reserves, and we have heard a great deal about the commercial troubles which may flow from that practice. We have heard a great deal about what is often done in practice, and, it may be, reasonably and properly done, but questions may arise some day, and possibly will arise, in some appropriate proceeding in order to find out and elucidate these very special matters. It was said by a very learned Judge on one occasion, by way of observation and not by judgment, that a company—that is to say the shareholders—could not complain if the position of the finances of the company was better than the accounts disclosed. That has been quoted from time to time as a justification for this method of keeping reserves secret. But there may be very great evils if those who have the control and management of the company, and who control and manage companies for the benefit of the shareholders who entrust their moneys to companies, if very large portions of the company's assets are left to the secret disposition of the managing authority. It may work very well in many cases; no doubt it does. It is a practice which is being followed no doubt by many concerns of the highest standing. On the other hand, it may be the subject of almost intolerable abuse. Such a system may be used to cover up negligences, irregularities and almost breaches of faith. It is said to be a matter of domestic concern between the company and the shareholders, but if shareholders do not know and cannot know what the position is, how can they form any view about it at all? How can they consider whether it is something which they are satisfied with or which they are not satisfied with?

The case was brought under the Larceny Act, 1861, and the learned Judge's reference to elucidation of the question in some appropriate proceeding is a clear indication that from a commercial standpoint regard should be had to a decision in a civil

action rather than in a criminal trial. In the Royal Mail case there was also the question as to whether the amounts which were utilized were secret reserves at all.

The view has been expressed that, while the accumulation of secret reserves may in many cases be quite proper and not at all open to objection, the utilization at a later date of such reserves, or any part of them (if the amount is relatively large), to increase the profits should be disclosed specifically in the accounts. This procedure, which is now adopted by many companies, might in some cases defeat the purpose of secret reserves. On a general view it seems proper that where the amount is relatively substantial, or where the practice of drawing on secret reserves continues year by year, disclosure should be made or some indication given to the shareholders.

The object of an internal reserve, when legitimately created, is the creation of a fund which will enable the Directors to meet any unexpected claim or liability without having to draw upon the admitted or disclosed reserves, and so avoid the disclosure of a loss to a rival company, or cause anxiety amongst their own shareholders by drawing upon the reserve shown in previous Balance Sheets.

The following examples will show how secret reserves can be created—

(*a*) By inserting in the Balance Sheet of an insurance company, under the heading representing the amount reserved to meet claims in respect of policies in force, a larger amount than is considered necessary, based on the experience in the past.

(*b*) By reserving a larger amount for possible loss on the realization of book debts than it is expected will be ultimately sustained.

(*c*) By valuing the investments below their true value on an independent valuation and below the original cost.

(*d*) By under-valuing the prices of material in stock or taking off an excessive discount from the manufactured stock-in-trade.

(*e*) By writing down buildings, plant and machinery, furniture and fittings at an excessive rate.

When an internal reserve is created with legitimate objects, for example, strengthening the financial position, an Auditor may not be justified in refusing to sign the Balance Sheet without comment. Many companies have "passed away" which might still be in existence had they created an internal reserve of a legitimate character.

Should, however, an Auditor believe that internal reserves are not being created in the interests of the company, but with ulterior motives, he should insert in his Report particulars as to

the internal reserves so that the shareholders may form their own opinion.

An objection to the creation of internal reserves is that it may deprive those who happen to be shareholders at the date of the creation of or addition to such reserve of the opportunity of participating in a higher dividend than that which is declared, although the profits may have been earned while they were shareholders. The Directors cannot have regard to the interests of individual shareholders as opposed to the interests of shareholders as a body, more particularly where the realization of shareholdings is the consideration in question. Their business is to administer the affairs of the company to the best of their judgment and to maintain its current resources in a liquid form. If an internal reserve is created for this purpose, the Directors may have ample justification and may be supported by past practice in their action.

LORD PLENDER'S OPINION

The considered opinion expressed by Lord Plender in 1932 is by his consent reproduced below

> Inner or secret reserves and their propriety—if not legality—have recently been the subject of judicial comment. Such reserves may exist, for example, in the excessive writing down of the book values of assets, of under-valuation of investments, or in provisions for contingencies the amount of which is not specifically set out on the Balance Sheet. In my opinion Directors should be entitled, in the interests of a company and its shareholders, to make reasonable provisions for contingencies and should be allowed discretion in so doing without necessarily being required to disclose the amount of the provisions in the Balance Sheet. . . . The reserve for contingencies is generally included in an omnibus item on the liabilities side of the Balance Sheet (such as "creditors including provision for contingencies"), and in my view it is necessary that its existence should be indicated by suitable wording. The use of such reserves in relief of losses or by way of supplement to profits should, I think, be indicated to the shareholders, and except in comparatively rare cases the amount so used should be stated. The origin and utilization of undisclosed reserves covers such a wide field of circumstances that it is not possible to dogmatize on the question, and a decision as to the right course to pursue can only be arrived at after a full consideration of the facts in each individual case.

CASES

The Directors of a company were empowered by the Articles of Association to create a Reserve Fund out of the profits of the company for such purposes as they should think conducive to the interests of the company, and to employ the Reserve Fund in the business of the company, without being bound to keep it separate from the other assets. The company had built up a Reserve composed partly of premiums received for leases, partly of premiums received on the issue of preference shares, and partly of

ordinary business profits. The Reserve was used in the company's business, and was not kept separately invested. The company had incurred a loss arising from the depreciation in the value of its public houses below the amount stated in the company's Balance Sheet. The company accordingly applied for the sanction of the Court to a scheme for reduction of capital, whereby the company, while retaining a small portion of the Reserve, attributed to the Reserve more than its rateable proportion, and to the Capital Account less than its rateable proportion of the loss.

Held, that the Reserve, having been properly created out of profits, in ascertaining the amount of capital lost, the loss of assets ought to be treated as rateably apportioned between the Reserve and the Capital Account, and that, in the absence of special circumstances, the company, in proposing a scheme for reduction of capital, was not bound to wipe out the whole of the Reserve, or to attribute to it more than its due proportion of the loss, though it might do so if it chose; and the Court sanctioned the scheme.—*Re Hoare & Co.*, [1904] 2 Ch. 208.

In a case where the Articles of Association of a company provided that the Directors might, in priority to any dividend, set aside out of "profits" any sum as a "Reserve Fund" for certain specified purposes, or "any other contingencies or purposes of the company," and might invest it; that any interest derived from such investment should be dealt with as profits; and that, subject thereto, "the entire net profits of each year" should belong to the shareholders, the Directors year by year carried part of the profits to three Reserve Funds, to meet (*a*) depreciation of steamers, (*b*) insurance, and (*c*) canal improvements; and the remaining profits, after providing for the preferential dividend, were distributed among the ordinary shareholders. These Reserve Funds were not represented by any separate or specific investments.

The company's undertaking was eventually sold by special Act of Parliament at a price which left a surplus in excess of the liabilities of the company and the capital paid up on the ordinary and preference shares. The sale was completed during the currency of a financial year. On the completion of the sale the company passed resolutions for a voluntary winding up. It had never been found necessary to resort to any of the Reserve Funds while the company was a going concern, and part of them had been in fact divided among the ordinary shareholders in the form of bonus; and at the date of the sale three funds representing these Reserve Funds were still standing in the company's books.

It was held by the Court of Appeal that all three Reserve Funds represented undrawn "profits" uncapitalized, and were, therefore, to be treated as income, to which, subject to the preferential

dividend for the broken financial year, the ordinary shareholders were exclusively entitled, and not as "capital" or "assets" distributable among both the ordinary and the preference shareholders; also, that in taking the accounts for the broken year, the value of the plant and book debts should be taken at the actual ascertained values as stated in the Stock Books, and not at the lower values at which the company had, according to their regular custom and from motives of prudence, estimated them in a previous annual Balance Sheet on which a dividend had been declared; and that the difference between the two values represented undrawn profits, to which, subject to preferential dividend, the ordinary shareholders were exclusively entitled.—*Re Bridgewater Navigation Company*, [1891] 2 Ch. 317.

The Directors of a company resolved to distribute accumulated profits as a bonus dividend of 50 per cent on the capital paid up, the dividend to be payable on the 6th of September, 1890. The dividend was, at the option of the shareholders, payable in cash, or applicable to the payment of the amount then due in respect of new shares or of calls. The old shares were £10 shares, some fully paid up or with £7 10s. paid up, in the proportion of one new share for every two old shares paid up, and one new share for every eight old shares with £7 10s. paid up. A call of £2 10s. per share was to be made at the same time on such of the shares as were not fully paid. The trustee of a will who held 150 old shares fully paid up (the tenant for life consenting, without prejudice to his rights to treat the dividend as income) accepted seventy-five new shares in lieu of the £750 bonus dividend on the 150 shares. The shares were sold for £1363. The tenant for life claimed £750 out of the purchase money on the ground that it was income; he did not dispute that the balance was capital.

It was held that the £750 was income, on the ground that the declaration of the bonus dividend and the issue of the new shares were two distinct transactions and not one transaction, as in *Bouch* v. *Sproule* (1887), 12 App. Cas. 385, the shareholders having the option of taking the dividend in cash without taking up the new shares.—*Re Northage, Ellis* v. *Barfield* (1891), 60 L.J. Ch. 488.

A company had an issued capital of 40,000 preference shares of £5 each fully paid and 60,000 ordinary shares of £5 each, of which 6047 were fully paid, and the residue were paid to the extent of only £1 a share. By the Articles of Association dividends were paid upon the ordinary shares in proportion to the amount paid up on the shares. The company had paid dividends and had accumulated a very large reserve fund consisting of undivided profits. A special resolution was duly passed and confirmed "That out of the accumulated profits of the company the sum of £4

per share be paid to the holders of 6047 fully-paid ordinary shares of the company by way of reduction of capital pursuant to Section 40 of the Companies (Consolidation) Act, 1908."

Held, that that Section could not be construed as authorizing the return of capital to the whole class of shareholders among whom the accumulated profits were divisible, and therefore the resolution was not *ultra vires*.—*Neale* v. *City of Birmingham Tramways Co.*, [1910] 2 Ch. 464.

CHAPTER XX

VERIFICATION OF THE TRANSFER OF SHARES, OF SHARE CERTIFICATES, AND OTHER DOCUMENTS RELATING THERETO

THE Auditor is not concerned with the rights of individual shareholders, but is frequently employed at a special remuneration to check all the work relating to transfers and share certificates and to report to the Directors of the company that the share certificates are in order for signature. No accounting principles are involved in this routine work, but the Auditor should be versed in the technicalities of transfer work.

In the first place it is essential that there should be an exact understanding between the Directors and the Auditor as to the extent to which the latter is to check the share records.

Most companies adopt the usual common form of transfer, but the Auditor should refer to the Articles of Association in this respect, and note whether they contain any special provisions relating to transfers.

The transfer deeds should be scrutinized to ascertain—

1. Whether the name and address of the transferor and numbers and distinctive numbers of shares transferred correspond with the share certificate surrendered, which should be *cancelled by the Auditor* and agreed with the Register of Share Certificates Cancelled and New Certificates Issued. (See *infra.*)

2. Whether the stamp duty impressed is correct. Transfers for a nominal consideration should bear the Inland Revenue adjudication certificate as an endorsement.

3. Whether the class of shares and name of the company are correctly stated, and whether there are any calls in arrear on the shares. If there are calls in arrear the Directors will probably desire to consider the circumstances before deciding whether to accept the transfer.

4. Whether the date is inserted and the signatures are duly witnessed. Regard should be paid to the regulations of the company as to the witnesses which may be accepted; e.g. some companies refuse to accept a wife as witness to her husband's signature. The signatures of parties abroad should be attested by a local consul or notary.

5. Whether the signatures of all the parties appear on the transfer and are in accord with the names set out in the deed.

6. Whether the signature of the transferor appears to correspond with previous signatures in the company's possession.

The Auditor is not necessarily an expert in handwriting and this form of verification is not always adopted unless by the express desire of the Directors.

7. Whether all alterations are duly initialed by all parties to the transfer.

It should be ascertained from the Share Register that the transferor is the registered holder of the shares transferred. This is *prima facie* evidence, but, unless every entry in the Share Register from the inception of the company has been checked by the Auditor, it would not be difficult for a fraudulent clerk or secretary to open a fictitious account in the name of a transferor in addition to forging a Share Certificate. If a "Register of Share Certificates Cancelled and New Certificates Issued" is kept (see *infra*), it would be necessary in a fraud of this kind, also to forge a certificate for cancellation and the Auditor's "marks" on the certificate.

It is the regular practice of most companies to notify transferors of the lodgment or certification of transfers purporting to be signed by the transferors, and the Auditor may ask to see the notices, and any objections which have been received. Unless the issue of the notices and the receipt of objections is carried out independently of the Registration Department of the company, this method of verification is not convincing, for the notices might not have been posted, or the objections might have been destroyed.

The new Certificates should be compared with the transfers in respect of the name and address of transferees, and numbers and distinctive numbers of shares transferred, and initialed or specially stamped if correct.

In cases where only part of a holding shown on a surrendered certificate is transferred, the new certificate for the unsold balance should be examined as to name and address, and numbers and distinctive numbers of shares.

The practice differs with various companies in the matter of balance certificates. Some only draw them on request, others draw them in every instance. The latter method, although involving more work by the company's staff, appears to afford a further check, provided a "Certificates Cancelled and Issued Book" is kept, showing on one side the shares represented by certificates surrendered for cancellation, and on the other those appearing on new certificates drawn, both sides agreeing in total. If such a book is kept the Auditor should examine it with the respective certificates, check the casts of the shares and agree the totals.

Where companies only draw balance certificates on request, the Auditor will require so to mark the certificates surrendered for cancellation (preferably by placing his initials against the entries endorsed thereon in respect of shares transferred), that he may

ascertain at any time how many shares remain untransferred and still held by the shareholder named thereon, or which may await further transfers by him not yet presented for registration. If balance receipts are issued they should be examined in the same way and the counterfoils of the balance receipts "marked."

The Auditor should ask for production of the company's "stop" list in respect of lost certificates, and notices of lien or distringas, and see that the transfers produced to him are not affected thereby.

If a Transfer Register is kept the entries therein should be compared with the transfers.

Before checking the postings to the Share Register the Auditor should examine the Directors' Minute Book to ascertain that the previous transfers checked have been duly passed by the Board for registration.

The amount received for transfer fees may be traced to the Cash Book, but this is usually part of the routine work of the audit of the company's accounts.

The audit of share transfers has made fraud much more difficult, even by means of forgery. The following cases are of interest, though they deal with administration rather than auditing.

1. It is a common practice to deposit with the lender blank transfers accompanied by a share certificate as security for a loan. The transfer is signed by the transferor, but particulars as to transferee and date of execution are not inserted. Until it is desired to lodge the transfer deed for registration the date should not be entered as the document must be stamped within thirty days of the date it bears.

The company is not concerned with a blank transfer, and will probably have no knowledge of it, but such a transfer may give a good equitable security in respect of the shares, whether the company requires transfers to be by deed or not.—*Société Générale* v. *Walker* (1886), 11 App. Cas. 20.

2. Should the transferor in blank execute another transfer, the transferee can establish a good title to the shares on registration of his transfer, and the blank transfer may be overridden.—*Peat* v. *Clayton*, [1906] 1 Ch. 659.

Share certificates almost without exception bear a note that no transfer will be registered without production of certificate. A company is usually prepared, however, to issue a duplicate certificate to replace a certificate which has been lost. In this case the shareholder to whom the duplicate is issued must furnish a letter of indemnity. Fraud is still possible, for a transferor who has signed a blank transfer and submitted his share certificate as security, can obtain a duplicate certificate from the company, though this would involve a fraudulent declaration in the letter

of indemnity that he had lost the original certificate. Having obtained the duplicate he could execute a fresh transfer, sell his shares, and submit the duplicate certificate. This emphasizes the importance of registering transfers as quickly as possible.

3. If a company is deceived by a forged transfer and registers the transferee and issues a certificate to him, and a third party acquires the shares from the transferee on the strength of the certificate, the company is liable to pay any loss which the purchaser may suffer when the shares are claimed by the real owner. —*Bahia* v. *San Francisco Railway Co.* (1868), L.R. 3 Q.B. 584.

4. If a Secretary fraudulently, without the authority of the Directors, affixes the seal of the company to share certificates, forging the signatures of the Directors, and issues such certificates, it has been held that the company is not liable to the holders of such certificates for valuable consideration.—*Ruben* v. *Great Fingall Consolidated Co.*, [1906] A.C. 439.

5. A person who presents a forged transfer in good faith and procures the issue of a fresh certificate is not liable to indemnify the company.—*Sheffield Corporation* v. *Barclay*, [1905] A.C. 392.

6. Section 101 of the Companies Act, 1929, provides that no notice of any trust may be entered on the Register. If the Directors have become aware that a transfer is being made in breach of trust or to defraud anyone having equitable rights in the shares, the Directors may become personally liable if they admit the transfer without having given notice to the person interested, but the company has no liability.—*Société Générale* v. *The Tramways Union* (1885), 14 Q.B.D. 424.

If a forged transfer is presented to and accepted by a company the transferee mentioned in the transfer does not obtain a good title. The true owner of the shares is, of course, entitled to demand that the shares remain registered in his name. If any dividends have in the meantime been paid to a person other than the true owner, the latter can claim payment from the company.

A third party acquiring shares on the faith of a certificate issued to a transferee under a forged transfer can claim to be indemnified by the company in respect of any loss suffered in consequence.

No notice of any trust, expressed, implied, or constructive, shall be entered on the register, or be receivable by the registrar, in the case of companies registered in England. (Companies Act, 1929, Section 101.)

CHAPTER XXI

AUDITING THE STATUTORY REPORT

SECTION 113, Subsections 1, 2, 3, and 4 of the Companies Act, 1929, reads as follows; it does not apply to a private Company:—

113. (1) Every company limited by shares and every company limited by guarantee and having a share capital shall, within a period of not less than one month nor more than three months from the date at which the company is entitled to commence business, hold a general meeting of the members of the company, which shall be called "the statutory meeting."

(2) The Directors shall, at least seven days before the day on which the meeting is held, forward a report (in this Act referred to as "the statutory report") to every member of the company.

(3) The statutory report shall be certified by not less than two Directors of the company, or, where there are less than two Directors, by the sole Director and manager, and shall state—

(*a*) the total number of shares allotted, distinguishing shares allotted as fully or partly paid up otherwise than in cash, and stating in the case of shares partly paid up the extent to which they are so paid up, and in either case the consideration for which they have been allotted;

(*b*) the total amount of cash received by the company in respect of all the shares allotted, distinguished as aforesaid;

(*c*) an abstract of the receipts of the company and of the payments made thereout, up to a date within seven days of the date of the report, exhibiting under distinctive headings the receipts of the company from shares and debentures and other sources, the payments made thereout, and particulars concerning the balance remaining in hand, and an account or estimate of the preliminary expenses of the company;

(*d*) the names, addresses, and descriptions of the Directors, Auditors, if any, managers, if any, and secretary of the company; and

(*e*) the particulars of any contract, the modification of which is to be submitted to the meeting for its approval, together with the particulars of the modification or proposed modification.

(4) The statutory report shall, so far as it relates to the shares allotted by the company, and to the cash received in respect of such shares, and to the receipts and payments of the company on capital account, be certified as correct by the Auditors, if any, of the company.

On the issue of a prospectus, a columnar list or book of the applications received in respect of each class of share is prepared for submission to the Directors of the company, who then settle the allotments to be made; it is completed by the insertion of particulars of the allotments. The list then contains the names and addresses of the applicants, the number of shares applied for, the money received on application, the shares allotted, the total amount payable on application and allotment, and finally the amount payable by the applicants on allotment or which may be repayable to those applicants who have not received an

allotment in full. The list, after approval by the Board of Directors, is signed by the Chairman.

The Auditor should—

(1) Verify the list by reference to the applications and allotment letters and the Minutes, tracing the cash received and paid through the company's banking account. (In the case of debentures, the same procedure is followed.)

(2) Check the entries in the Share Ledger with the application and allotment lists or book.

(3) Check return of application money or a part thereof to persons to whom shares have not been allotted or who are entitled to a return of cash because a full allotment has not been made to them. Where a partial allotment is made, the excess application money is, in the first instance, utilized in paying the amount due on allotment, leaving a balance due to or by the applicant.

(4) Check the receipt of cash for calls on the shares and examine the minutes of the Board of Directors in regard thereto.

(5) Verify that the provisions of the Memorandum and Articles of Association have been complied with and the minimum subscription made.

(6) Check all commissions for underwriting or otherwise and verify that the provisions of Section 43 of the Companies Act, 1929, have been complied with.

In addition to the receipts and payments on capital account, the Statutory Report must exhibit the receipts from other sources and all payments made, though not necessarily of a capital nature. The Auditor, although for his own satisfaction he may vouch all cash transactions, has only to certify as to the shares allotted and to the cash received in respect of such shares and to the receipts and payments on capital account, which he will examine and vouch in the usual way. The usual form of audit certificate is as follows—

I certify that so much of the above report as relates to shares allotted by the company, to the cash received in respect of such shares, and to the receipts and payments of the company on capital account is correct.

CHAPTER XXII

HOLDING COMPANIES AND SUBSIDIARY COMPANIES

THE development in comparatively recent years of the subsidiary company has proved to be of great importance to accountancy and commerce. The practice involves the existence of a parent company—usually called a "holding company"—and one or more companies called "subsidiary companies" over which by virtue of a shareholding or otherwise the holding company exercises control. Control may arise by means of the possession of more than 50 per cent of the issued share capital of the subsidiary or of such an amount of the share capital as will entitle the holding company to more than 50 per cent of the voting power. Again, although the holding company may not possess the amount of share capital laid down by the Companies Act, 1929, it may exercise control of the subsidiary company by virtue of a right, directly or indirectly, to appoint the majority of the Directors of the other company.

The existence of the holding company and the subsidiary company are recognized in the Companies Act, 1929, and in Chapter IX (pages 111 and 112) were quoted the sections which contain a definition, for the purposes of the Act, of a subsidiary company, and certain regulations affecting them.

Although the holding company may frequently be referred to as a parent company, it does not necessarily follow that this defines the true relationship as that of father and child. In company matters the child may so far contravene the laws of nature as to precede the father. The existence of holding and subsidiary companies may arise in several ways of which the following may be cited—

(1) The acquisition by a company (holding) of a controlling interest in an existing company by the acquisition of a majority of the shares or otherwise.

(2) The formation by a company (holding) of a subsidiary company, by registration in the ordinary way, and the acquisition by purchase or otherwise of a controlling interest in the company. In this case it may be that the holding company (in its own name or the names of nominees) will acquire the whole of the shares, in which case the subsidiary company will become a "wholly-owned subsidiary."

(3) The division of an existing company into two or more separate companies of which one becomes the holding company and the remainder subsidiary to it.

(4) The formation of holding and subsidiary companies as above, and the further formation of companies subsidiary to existing subsidiary companies—known as sub-subsidiary companies. In this case grand-parental control is exercised over the grandchildren by reason of the control of the grandchildren's parents.

The complications, both of accountancy and of direction, which the existence of subsidiary companies entails, are so numerous that it is of interest to examine the considerations which prompt and appear to justify their formation.

The first consideration, and a very practical one, is the desirability of maintaining the name and constitution of a business which has been acquired by another (holding) company. There may be some goodwill in the name, with which its products may be connected; or, the business may be self-contained and different from the business of the holding company and for this reason it may be better to keep it as a separate entity. It is therefore more convenient to deal with the acquisition by a purchase of shares than to liquidate the company and incorporate the business in that of the holding company.

A second consideration, applying particularly to foreign subsidiary companies, is the probable desirability or necessity of having a separate local legal entity. This is important where locally domiciled companies have rights or privileges not accorded to foreigners or where non-domiciled companies are subject to certain disabilities; this question is often material in relation to the incidence of taxation whether in the United Kingdom or in the country concerned. For example, in Spain the annual Capital Tax was levied on the whole capital of a company conducting operations in Spain although its Spanish activities might be a relatively small part of its total business. For this reason many companies found it necessary to form separate Spanish companies for their operations in Spain, so limiting their tax liabilities to such sums as might conveniently be agreed with local tax authorities or collectors according to their respective needs and requirements.

A third consideration is the necessity in many cases for anonymity. It is frequently undesirable that the public and competitors should be aware, at any rate at first, of the acquisition of one company or business by another. Secrecy can be preserved to some extent by the maintenance of the acquired business as a subsidiary company, the shares being held by nominees of the holding company. In these days it is not easy to keep anything secret for long, but it may be possible by the use of nominees to conceal the exact extent of the holding company's interest.

A fourth consideration is the means which it may offer to secure the most favourable incidence, or even the avoidance, of taxation,

especially double taxation; to escape the effect of certain legislation, and to limit or control publicity as to the subsidiary company's activities and the possible formation of hidden reserves. Abuse of the subsidiary company has led in recent years to a number of prosecutions of Directors, while certain uses not amounting to abuses have led to restrictive legislation. The most recent example of legislation of this character is the Finance Act, 1936, Section 19 of which widens the net which catches for sur-tax assessment the undistributed income of certain companies.

The whole question of subsidiary companies was considered by the Company Law Amendment Committee which reported in 1926, and many of its recommendations were adopted and are incorporated in the Companies Act, 1929. These provisions, which affect only those companies which are incorporated under the Companies Acts, are referred to earlier in this chapter and the requirements are clear. Certain aspects of these provisions and their effect on the presentation of accounts should, however, be considered, and in addition some points of definition. It is not possible within the limits of this volume to consider the presentation of accounts in detail, and the reader is referred to the late Sir Gilbert Garnsey's book on *Holding Companies and their Published Accounts.*

A holding company in the more generally accepted sense of the term connotes a company which holds shares in one or more subsidiary companies, and collects dividends from them and pays dividends, out of that income, to its own shareholders. The term has a wider application, however, and is also applied to a company which itself carries on a business, and in addition has a controlling interest in subsidiary companies. A company of this kind derives its income from its business operations and from the subsidiary companies.

The term "subsidiary company" is applied to a company in which the holding company has a controlling interest, as defined earlier in this chapter. This interest may be anything from a bare majority to complete ownership of the share capital (the latter being usually called a "wholly-owned" subsidiary). A bare majority will enable a holding company to give an effective vote on most resolutions, though there are some resolutions for which a three-fourths majority is required.

Opinions differ as to the manner in which the profits and losses of subsidiary companies should be dealt with in the accounts of the holding company. It must be remembered that a subsidiary company is a separate legal entity and must prepare and publish its own accounts in the same way and subject to the same legal provisions as other companies of the same kind, without any regard to parental control. Obligations are, however, imposed on

the holding company, under the sections referred to above, (*a*) to publish separately in their accounts shareholdings in subsidiaries and indebtedness to or by them, and (*b*) to annex to the Balance Sheet a statement as to how the profits and losses of subsidiary companies, so far as they concern the holding company, have been dealt with in its accounts and to what extent provision has been made for, or account taken of, their losses. The latter statement, as usually published, is of little value, more particularly since it is not necessary to specify the amount of the profits or losses. The Auditor takes no responsibility for this statement and it should appear below his report to the members.

The simplest procedure for dealing with profits and losses, and one which naturally suggests itself, is to include in the accounts of the holding company the dividends received on its shares in the subsidiary company. This method may be said to suffer from the objection that hidden reserves can be built up by under-distribution of profits, and further dividends receivable by the holding company may be adjusted year by year in such a way that the accounts of the holding company do not give a clue to the true operations, and opportunities are provided for manipulation, since the shareholders of the holding company do not see the accounts of the subsidiary.

Another procedure, which many support, is to incorporate in the accounts of the holding company the proportion of the profits earned by the subsidiaries which is attributable to its shareholdings, whether the subsidiaries have distributed a dividend or not. In the case of a wholly owned subsidiary this practice may well be justified, for such a company is, in effect, a branch of the holding company. But in any case there is the danger that an asset will be raised in the Balance Sheet of the holding company for a dividend which may not in fact be distributed at any time. Again, unless the accounts of the subsidiary are prepared to the same date and cover the same period as those of the holding company, a distorted result is produced and a true picture is not obtained.

So far as losses of subsidiaries are concerned, unless provision is made for them in the accounts of the holding company, an adjustment should be made in the value attributed to the shares of the subsidiaries in its Balance Sheet having regard to such losses. Where, however, there is a group of subsidiaries it will be proper to consider profits and losses in the aggregate unless there are exceptional circumstances affecting the losses which would make some provision desirable. In the case of the acquisition by a holding company of shares in a subsidiary company having undistributed profits, such undistributed profits—to the extent to which they may be said to belong to the holding company

should be regarded as capital, when distributed, and utilized to write down the value of the shareholding. There appears to be no legal obligation to treat dividends paid out of the undistributed profit as capital.

It is sometimes suggested that not only should the accounts of wholly or almost wholly owned subsidiaries cover identical periods and have Balance Sheets all on the same date, but that such companies should all have the same Auditors. For purely personal reasons such a proposal would not meet with the warm approval of those Auditors of subsidiary companies who would necessarily be displaced. Sir Thomas Keens expressed this view very strongly at the International Congress on Accounting held in London in 1933. He further considered that in the case of the Gargantuan undertaking with hundreds of subsidiaries, the amount of devolution of work that would have to take place if one Auditor were appointed would mean that no advantage would be gained, and that a conference of Auditors concerned in the audit of the accounts of the various companies would be more effective.

Although there is no legal necessity for consolidated statements, the natural demands of shareholders of a holding company for information as to the group of companies which it controls can be met by the submission of a consolidated Balance Sheet and consolidated statement of profits and losses. The extent to which these statements aıe analysed will depend first of all upon the purpose which a fully analysed statement will serve, and secondly, the similarity or otherwise of the items in the various companies' accounts. The multiplication of headings and the amplification of information may be carried to such an extent that the average shareholder may have the greatest difficulty in gleaning any facts at all. Some of the elaborate accounts which are furnished to shareholders in the United States convey to them very little but the impression that a large part of their profits goes to the printers.

A consolidated Balance Sheet wherein the various assets and liabilities of subsidiary companies are helpfully summarized with those of the holding company, may, however, furnish a very useful picture of the group. Any such statement is only a statistical memorandum and does not take the place of the respective legal Balance Sheets which must be prepared and submitted to the members. In any case in which the holding company possesses only a part of the share capital of a subsidiary, account must be taken in the consolidated Balance Sheet of the interests of the outside shareholders. In all cases inter-company indebtedness should be eliminated.

A consolidated memorandum statement of profits and losses of subsidiaries is also desirable, presented in such a form that

the shareholder is enabled to assess the earning capacity of the group in which, as the owner of shares in the holding company, he is interested. It will be seen that if such a deduction is to be drawn the accounts of the subsidiaries should be prepared on a uniform basis and all large items of an exceptional or non-recurring nature should be separately stated. The reader is referred to the *Royal Mail Case* (*R.* v. *Kylsant*, [1932] 1 K.B. 442) for further views on this point. He should, however, bear in mind that the case was a criminal one under the Larceny Act, and that the considerations which would have been necessary to establish guilt in that case in regard to the published accounts should not furnish the standard which he ought to set himself in determining how accounts should be presented, if full information is to be given to satisfy the reasonable demands of shareholders.

CHAPTER XXIII

LOOSE LEAF LEDGERS, CARDS, AND MECHANIZED ACCOUNTING

LOOSE leaf ledgers and cards as substitutes for ordinary books are extremely useful for statistical purposes and facilitate the division of labour, so avoiding congestion and saving time.

The use of loose leaf and card methods and mechanical accounting does not affect the principle of an audit, but it does necessitate some variation in the routine work. As the loose leaves and cards, even if numbered, cannot be arranged in consecutive numerical order, the postings can only be checked by calling from the loose leaves or cards to the subsidiary books. This occupies more time.

It is beyond the scope of this work to set out the various methods of mechanical accounting in use. The Auditor must master the particular system employed and satisfy himself that the automatic mechanical proof claimed for the machines is reliable. Most accountants now use certain machines in their own offices and can, if necessary, make an independent check in this way. Calculating machines (which are also adding machines) undoubtedly save the Auditor a great deal of time which can be applied to important matters requiring more than arithmetical checking.

A SIMPLE ILLUSTRATION OF THE USE OF CARDS

In the case of a club distinctive cards can be prepared for each class of member. Two drawers are provided for each class of member, one labelled "Subscriptions Paid" and the other "Subscriptions Unpaid." As the subscriptions are paid, the cards are transferred from the "Unpaid" drawer to the other one. As a result, a list of subscriptions outstanding can be taken out very quickly by reference to the "Unpaid" drawer. Where the terms of membership may vary, as, for example, when a town member becomes a country or foreign member at a reduced subscription, the cards need only be removed to the appropriate drawers. A register of any transfers of this nature should be kept, based upon the Minutes of the committee (which should record all additions to membership, resignations and change of status). This provides for an effective check on the cards.

A COMPLETE MECHANICAL ACCOUNTING SYSTEM

The following outline of the system used for the production of all the financial and statistical records required by a well-known company is reproduced by the courtesy of *Industry Illustrated*.

The main operations undertaken by the machines may be summarized as follows—

1. Recording of purchase orders and of goods received.
2. Recording of invoices for expenses incurred and goods purchased, with subsequent preparation of Bought Day Book and suppliers' Personal Ledger.
3. Preparation of Cash Book and bank paying-in slips.
4. Preparation of the Petty Cash Book.
5. Recording issues of stores.
6. Preparation of the Salaries and Wages Books.
7. Preparation of manufacturing and packing costs of all finished products.
8. Recording of sales and consequent analysis. Preparation of Sales Personal Ledger. Preparation of customers' statements. Analysis of sales by territory. Analysis of sales by representative for commission calculation.
9. Preparation of the Journal, Bills Book, and so on.

Recording of Purchase Orders and of Goods Received. The purchase order which is prepared by the purchasing department carries the code number of the goods ordered, in addition to their description. The supplier is asked to quote the code number on all delivery notes and invoices. The punching of the necessary card is made from the copy of the purchase order. When the goods are received, duplicate "goods in" dockets are prepared by the warehouse clerk stating the supplier's name and ledger folio. These dockets are sent to the stock receiver who is responsible for opening and checking the goods and for completing the dockets with the correct stores code numbers, and the precise quantities of units received. One copy of the "goods in" docket is the basis for punching the "goods in" card. These cards are tabulated and called over and after verification are sorted, in sequence of suppliers and stores code number. "Goods in" sheets are then prepared from the cards and passed to the employee responsible for checking invoices for payment.

At the end of each month (or more frequently if requested by the purchase department) the cards representing "orders placed" and "goods received" are sorted and tabulated. The purchase department can thus see at a glance the balance outstanding on all uncompleted orders. As orders are completed, the particular cards are extracted by hand, leaving in the filing cabinet only those representing uncompleted orders.

Recording of Invoices. All invoices received for supplies or expenses incurred, such as rent, rates and taxes, advertising, and so on, are handed to one particular clerk—"Invoice clerk"—who numbers the invoices consecutively, codes them with the suppliers' folios and divides them into two batches—(*a*) stores invoices, (*b*) expenses.

Stores Invoices. These are checked with the "goods in" sheet previously referred to, and completed for the code number of the goods and of the store account if these have been omitted by the supplier.

Expenses Invoices. These are passed to the various departments responsible for authorization, who indicate the account to be debited. They are then returned to the Private Ledger clerk for indication of the account code number. When the extensions have been checked all invoices are passed back to the invoice clerk who, after checking the sequence of numbers (to ensure that none have been mislaid or lost), hands them over for punching. The cards having been punched, a rough tabulation is made for checking purposes and they are then sorted into:

Suppliers' account cards (credit) and
Stores account cards (debit)

and the necessary tabulations prepared.

Bought Day Book. Both debit and credit cards are now merged and tabulated for totals only, to obtain the necessary figures for the Private Ledger Control Accounts. The cards may now be filed in the "ready for posting" cabinet.

Preparation of Cash Book and Bank Paying-in Slips. Receipts are recorded by punching a credit card for each receipt, the information being obtained from the cashier's receipt counterfoil. The cashier is responsible for indicating on each counterfoil the Ledger folio of the customer.

A debit card with the supplier's folio in the sterling folio field is punched for each payment, the necessary information being obtained from the cheque counterfoils. By sorting on the contra account field and tabulating the information for punching total credit cards is obtained.

The debit and credit cards prepared as above are tabulated daily in Cash Book form, thus controlling the daily balance of cash at the bank.

When the debit side of the Cash Book is being tabulated the machine automatically prepares at the same time a duplicate perforated counterfoil which is used as a bank paying-in-slip.

The debit and credit cards for customers' and suppliers' accounts are filed in a special drawer until the end of the month, when they are sorted on the sterling Ledger indicator and tabulated on the last sheet of the Cash Book. The tabulator is set to produce only the total affecting each Ledger, thus providing the information for the Private Ledger Accounts.

After agreeing the control totals with the Cash Book totals, the personal cards are put into the "ready for posting" cabinet.

Finally two total cards are punched for total cash received and total cash paid out, for posting to the cash account in the Private Ledger. This obviates the necessity for entering the original detail cards separately into the cash account in the Private Ledger.

PETTY CASH

Preparation of Petty Cash Book. The Petty Cash Book is prepared on the same lines as the Cash Book, except that all cards are punched from the information on the petty cash requisition slips.

Whilst on the subject of cash and petty cash, it will be generally recognized that the contra entries need not always be of a personal nature—payments are made for direct debits to expense accounts such as travelling expenses, and so on. In such a case the voucher employed to supply the information to the punch operator, gives such other information as necessary, e.g. territory or department to be debited. This information is punched in the original card representing the Cash Book entry, so as to provide full information on the tabulation from which the debit cards are produced.

Recording Issues of Stores. Only certain specified persons, such as departmental chiefs, factory main stock keepers and floor foremen, are authorized to requisition for stores. A stores code is issued to employees authorized to requisition and they are responsible for the correct code numbers to be indicated on the requisition. They are also responsible for indicating the precise account to be debited with the stores issued. The stores are grouped into three main sections—

(*a*) Office expendable stores—i.e. literature, stationery, window bills, and so on.

(*b*) Raw materials for manufacture.

(*c*) Packing materials.

Original drawings from main stocks are always requisitioned on special buff forms numbered consecutively by the printer. Such requisitions

indicate whether the stores are drawn for direct charge to an expense account, or for manufacturing or packing.

In the former case, requisitions are completed by the storekeeper issuing the stock, and then sent to the pricing department (referred to previously as the Invoice or Bought Ledger clerk) which prices them, then hands them to the calculating machine operator for extensions and finally passes them to the punching department.

STOCKS ON HAND

With regard to requisitions for stock drawn for manufacture or packing —these are used merely for controlling the movements of stock. As far as actual Ledger Stock Accounts are concerned, stocks in hand are total stocks without regard to their position. The floor foreman having drawn stock for manufacturing or packing, renders a job sheet daily showing the materials used and the purpose for which they are used. These sheets are passed to the "invoice clerk" who prices them. A calculating machine operator extends the values and a punching clerk punches credit cards for the stores accounts concerned, entering the store account folio in the sterling folio field and manufacturing account or packed article account number in the contra folio field. The cards are then tabulated and checked with the original floor foremen's sheets. When verified, they are sorted on the contra folio field and a tabulation prepared with the tabulator set to control for totals only on the contra folio field. The total material costs of each article manufactured or packed are thus ascertained.

Debit cards are punched for the above-mentioned totals—the manufacturing or packed stock folio being entered in the sterling folio field, and the Stores Day Book number being entered in the contra folio. These cards are then tabulated in the Stores Day Book, printing out every card with a grand total of debits and credits at the finish.

When the above work is completed the cards are sorted on the Ledger indicator and tabulated to give the total per Ledger for Private Ledger control purposes. All cards are then put in the "ready for posting" cabinet.

Preparation of Salaries and Wages Book. Three cards are used in this operation as follows—

(*a*) Deduction card,
(*b*) Office salaries,
(*c*) Factory wages.

The pay roll is produced by bulking and sorting cards (*a*) and (*b*) on clock number. The tabulator automatically subtracts the deductions and gives the net amount payable. Deduction cards are then abstracted and filed ready for the following week's wages. Cards (*c*) are filed in a special storage cabinet as from them department or job analyses are obtained and they are also required to produce the income tax register and the Workmen's Compensation Act figures. Cards (*c*) are filled in daily by the floor foremen, who complete a card for each separate operation undertaken by each operative, showing the operative's clock No., the hours worked, the job or packed article stores No. (entered in sterling folio field), the floor No., the particular operation No. and the rate of pay. These are costed daily. In view of the fact that the total of the fractions of hours worked on different operations does not always agree exactly at the end of each week with the timekeeper's clock record at the factory gates, a separate card is punched every Thursday for the total number of hours the man has recorded in the timekeeper's office. This is the card which is used in conjunction with the deduction card for the production of the factory pay roll. For this operation the same procedure is employed as was used for the production of the office pay roll, except that before the card is filed for income

tax purposes, the daily cards are sorted under clock No. and reconciled with the amounts to be paid as appearing on the pay roll. The daily cards thus form the medium for production of costing statistics and are stored in a special cabinet until the end of the costing period—the last Wednesday in every month.

Preparation of Manufacturing and Packing Costs. At the end of the costing period the daily wages cards are sorted on sterling folio field and tabulated on stores and packed stock wages detail sheets, the tabulator controlling and printing out totals per sterling folio.

This tabulation gives the wages cost of production for each manufactured product and for each packed unit of stock. The detail cards are now filed for future reference such as obtaining analyses of operation costs. The next operation is to punch a debit stores card debiting the wages costs obtained from the above-mentioned tabulations to their respective Stores Accounts. The contra folio is that of Wages Account and a card is punched to credit that account in total. Debit and credit cards for wages having been produced, and the totals agreed, they are sorted and tabulated, controlling on Ledger indicator for Private Ledger control purposes, and are then filed in the "ready for posting" cabinet.

Recording of Sales. For every customer on the company's books there are two cards. One (5 in. by 8 in. Kardex) contains full details of all sales made to the customer during the quarter (the information being obtained from a Powers machine analysis) and a small insert card termed "information card." On this card, in addition to the information required by the sales manager, there is the necessary "Powers" information.

All orders are sent from the post department to the sales department who complete the order form by filling in stock account folio, and by attaching the "information card" extracted from the Kardex Cabinet.

Sales Detail Cards

The invoice section of the sales department make out four copies of each invoice on a multi-biller, inserting the necessary "Powers" details from the "information card." One copy of the invoice is sent to the Powers department for punching. These cards so prepared are termed the sales detail cards. They are punched as credits, the stock account folio appearing in the sterling folio field and customer's folio in the contra folio field. They are then sorted and tabulated, controlling on invoice number, printing out each card and totalling by invoice number. This tabulation is done on plain roll paper, which is passed to the punch operator for punching debit cards (Personal Ledger cards).

These cards, having been tabulated and checked for accuracy, are filed in a special "sales record" box until the end of the month. In the meantime the sales detail cards have been grouped according to the analysis required (in the system under review—by products sold) and tabulated daily to enable a running total of the finished products analysis to be maintained throughout the month. At the end of the month, credit cards are punched for the totals of sales made, to the credit of the respective Sales Accounts in the Private Ledger.

The daily detail cards are now filed away in the sales detail cabinet until required for analysis, e.g. territory sales, representatives' commission, and so on.

The customer's debit cards and the sales account credit cards are now merged, sorted and tabulated, controlling for totals on the sterling folio Ledger indicator for Private Ledger control purposes. After control cards have been punched from the tabulation so obtained, all the cards are filed in the "ready for posting" cabinet.

Preparation of the Journal Bills Book. The Journal is prepared from numbered Journal vouchers which contain fully detailed information. The vouchers are carefully stored by sequence of numbers in bound files for ready reference, and as a result the cards need only be punched to debit or credit the correct account and to record the correct voucher number.

After the cards have been punched, they are tabulated to produce the Journal and the necessary information for Private Ledger control purposes. They are then filed in the "ready for posting" cabinet. The Bills Book is produced in exactly the same manner as the Journal.

Monthly Posting. At the end of each month all the cards for that month have been collected in the "ready for posting" cabinet. Incidentally, as the cards have been put into this cabinet they have been filed under their respective ledger indicators, this being a simple matter as the last operation prior to filing has been to sort by Ledger for Private Ledger control accounts.

Sales Ledger. In the Sales Ledger section we have filed the cards recording goods sold, cash received and perhaps a few cards from the Journal. These are all sorted on sterling folio and statements are produced by the tabulator on long roll statement forms of a special design. These statements are then sent up to the addressograph department for addressing, and are posted. The cards are then available to make the Ledger postings. To post the Ledgers, the cards are tabulated on the rough continuous roll paper. This serves a dual purpose—

(1) It provides the posting operator with information as to the particular accounts which he has to post (this method is found more expedient than handsorting cards and off-setting those accounts to be posted).

(2) It also provides the necessary information in compact form for punch operators to punch opening balance cards, which, when punched, are put in the "ready for posting" cabinet for the new period.

When the Ledger has been posted, the cards are destroyed.

Purchase Ledger. In the Purchases or Suppliers Ledger section, the cards have been collected from the Bought Journal for goods supplied, from the Cash Book for cash payments and possibly from the Journal for discounts and adjustments. The cards are sorted on sterling folio, and a special tabulation is run off controlling on sterling folio. The tabulation is made on Journal sheets and handed to the Bought Ledger invoice clerk who checks up the detailed accounts with the suppliers' statements. When verified, the statements are sent down to the cashier for payment. This method is adopted as it is not always found possible actually to post the Purchases Ledger in time for "settlement" day. The method of finally posting the Suppliers' Ledger and producing balance cards, for the new balances, is the same as that adopted for the Sales Ledger.

Stores and Raw Materials Ledger. The "ready for posting" cabinet contains the debit cards for stores purchased, and the credit cards for issues. The method of ascertaining the correct accounts to be posted, the posting of same and the production of opening balance cards for stock in hand, is the same as that adopted for the Personal Ledgers, with one exception.

The Stores Ledgers are intended to control the physical stocks in addition to showing at a glance their sterling value. The tabulator, owing to the volume of other information required, is able to throw out only sterling balances. The stock balance is ascertained by a calculating machine operator from the preliminary tabulation of the cards, which as mentioned before, is run off primarily to indicate accounts to be posted, and the amount of the balance to be carried forward. The preliminary tabulation of stores ledger cards thus serves the following purposes—

(1) Indicates the accounts to be posted.

(2) Allows the calculating machine operator to enter the difference between stocks received and issued (i.e. the balance in hand in quantities).

(3) Provides a basis for punching cards for stocks carried forward.

(4) Provides a control on the physical stocktaking.

The manufacturing and "finished article" Ledgers are handled in precisely the same manner as the Stores Ledger, except that in addition to the four uses obtained from the production of the preliminary run off, the sheets are also used for ascertaining the unit cost of production.

Private Ledger. The Private Ledger is handled in much the same way as the ordinary personal Ledgers, with, however, a further use of the preliminary run off. As already mentioned, the sequence of accounts is arranged in such a manner as to produce the tabulation in the same order as would be required for the company's final Trading Account, Profit and Loss Account and Balance Sheet. The preliminary tabulation is, therefore, used as a monthly Balance Sheet and Profit and Loss Account. The cards used to produce the Private or Nominal Ledgers are not destroyed until the annual audit is completed.

CHAPTER XXIV

METHOD IN THE BALANCING OF BOOKS

THE balancing (or agreeing) of a set of books—the operation by which the accuracy of the books is tested and proved—is based upon the well-known principle of book-keeping by double entry that "every debit must have a credit."

Books written up on this principle contain the accounts of the trader himself (subdivided under many headings, such as Goods Account, Stock Account, Cash Account, and so forth) as well as his accounts with those with whom he deals. If, for example, a trader sells goods of the value of £10 to John Black, he makes entries the effect of which is to debit John Black with £10 and credit himself, under the heading of "Sales Account," with the like sum. Similarly, if he receives £10 from John Black, he makes entries the effect of which is to debit himself under the heading of "Cash Account," and to credit John Black with that sum. The principle is readily grasped by inspecting, in old text-books on the subject, the old-fashioned system of book-keeping, in which the totals of the transactions of each month (shown in detail in the Cash and Day Books) were journalized monthly for the purpose of posting the totals to the Impersonal Accounts in the Ledgers. By this means every debit is clearly shown to have its proper credit, and as the debits and credits in the Journal are cast up and agreed in total, it is demonstrated every month that the total debits do equal the total credits. Modern book-keeping methods of which columnar records are the important feature, while conserving the principle of double entry, have to a great extent cut out the Journal, and in doing so, though saving much time, have somewhat obscured the double entry principle. In fact, a superficial student may well overlook it, unless he has mastered the old-fashioned methods before adopting the new.

To anyone who thinks the matter out, it is clear, as already mentioned, that not only do books kept on the double entry principle contain the accounts of the trader himself and of his creditors and customers in relation to him, but that the double entry also enables the accuracy of the books to be absolutely proved by taking out a Trial Balance. If the entries be correctly made and correctly posted to the Ledgers, the totals of all the debits in the Ledgers must agree with the totals of all the credits. As a matter of arithmetic, it follows that if the debit and credit balances of each Ledger Account be correctly extracted and added up, the total of the debit balances must agree with the total of

the credit balances. The balance of the Cash Book must also be brought into the Trial Balance, for in modern book-keeping the Cash Book is made to serve both as a Cash Book and as a Ledger. From it the trader posts the receipts to the credit of his customers and the payments to the debit of his creditors. Strictly speaking, he ought to post to the debit and credit of himself, as it were, under the heading of "Cash Account" in the Ledger, debits and credits to correspond. As, however, the balance of such a Cash Account, if it were raised in the Ledger, would obviously be the same as the balance of the Cash Book, the practical trader saves time and avoids repetition by treating the Cash Book also as a Ledger Account (his "Cash Account," in fact), the surplus of receipts over payments being clearly a debit balance.

For the purpose of balancing books correctly and intelligently, a grasp of the principle explained above, that every debit must have a credit, is absolutely essential, and as the balance to be reached is not merely a mechanical summary of figures, but is intended to be the basis of a true and correct Balance Sheet, it is necessary to see that every debit has its *proper* credit, and vice versa—more especially in the case of Journal entries, which offer scope for errors of principle or for manipulation.

As to methods of balancing, the simplest illustration of all is that of a private individual keeping only a Cash Book and Ledger. Probably without appreciating it, he is keeping his books by double entry. The principle is, in fact, automatically applied. He debits his Cash Account with each item he receives and posts the amount to the credit of a personal or impersonal Ledger Account; similarly, he credits his Cash Account with each payment he makes and debits a Ledger Account, so that he has, in fact, made "a debit for every credit." The result is that if he takes out the Ledger balances, putting the debits in one column and the credits in the other, including, as already explained, the cash balance, and adds up the respective columns, the totals ought to agree. If they do not, all he has to do is to check the casts of the Cash Book and Ledger and the postings to the Ledger until he detects the difference. In so simple a case, there should be but little difficulty in doing so.

In the case of a large commercial house, with many transactions, of which cash items form only a part, it is a different matter. Experience, method and system, absolute accuracy and a clear head are necessary to rapid balancing without waste of time upon unnecessary work. The following system methodically followed out, should enable any set of books to be agreed "to a penny"—as all books ought to be—within a reasonable time.

(1) Procure a list of the agreed balances at the beginning of the year. See that they do agree—total debit with total credit

balances. Compare each balance in the list with the balance brought down in the corresponding Ledger Account, and if correct mark off with a small distinctive tick in front of the balance both in the list and in the Ledger thus: ✓×. This precaution ensures that the books do agree at the commencement of the year.

(2) Compare all the postings from the original books (Day Book, Cash Books, etc.) to the Ledgers. As they are called off, and if they agree, mark each item both in the Day Books and Ledgers with a distinctive tick in front of the figures thus: ✓.

(3) Check the castings of the Day Books and Ledgers, and if correct make a distinctive tick the same in form as the tick for balances, but *below* the figures.

(4) Tick off all transfers, if any, from one Ledger Account to another, that is to say, transfers made direct and not passed through a Journal (as they should be), ticking these contra entries, if correct, with a distinctive tick in front of the figures thus: ✓×. If there are no Journal entries, make a list of these contras, as and when checked, so that they may be re-checked readily if necessary. It is not uncommon for such transfer entries to be posted to the wrong side of the Ledger, and the mistakes may be passed over if the checking be done in a perfunctory manner or by the inexperienced.

(5) See that every posting and casting in the Day Books and Ledgers *is* duly ticked off. Where the castings cannot immediately be inked in, make the ticks in pencil for the time being.

(6) The colour of ink used for checking should be red one year and blue the next, and so on in alternate years. This variation in the colours is invaluable in detecting errors of date, and enables one readily to distinguish one year from another, especially when taking out balances. It enables errors to be detected which might otherwise be passed over again and again if the ticks were the same colour each year.

(7) The next step is to extract the balances at the close of the year. They should be taken down on single sheets of double money column paper, only one side of the paper being used. The debit balances are to be put in the left-hand column, the credit balances in the right-hand column (*vide* illustration, Schedule I). The sheets relating to each Ledger or class of Ledgers should be numbered and arranged consecutively and each sheet cast up. The casts should not be carried forward from sheet to sheet, but a summary for each class of Ledger should be made of the totals of each sheet. The sheets and summary should then be fastened together, the summary (*vide* illustration, Schedule II) on the front and the sheets following in sequence by numbers. Summarizing the sheets saves a great deal of time and trouble, as an alteration in any figure only involves altering the sheet to which

it relates and the total in the Summary, instead of having to alter the casts through all the sheets.

Another method is to cast up the debit and credit totals of the Ledger Accounts and take out the totals on single sheets with four money columns (entering the totals on the first two columns, the debit on the left and the credit on the right as before), and after the totals have been agreed, to throw out the balances into the remaining columns (*vide* illustration, Schedule III).

SCHEDULE I

SALES LEDGER BALANCES.—31st December, 19..

Fo.	Name	Amount Dr. £	s.	d.	Amount Cr. £	s.	d.
1	Andrew, P.	500	0	0			
	Allison, G.	20	0	0			
	Brown, K.	110	0	0			
	Brough, R.	43	3	0			
	Bedells, F.				10	0	0
	Collison, E.	180	0	0			
	Carlisle, T.	150	0	0			
	Total to Summary . £	1003	3	0	10	0	0

SCHEDULE II

SUMMARY OF SALES LEDGER BALANCES.—31st December, 19..

	£	s.	d.	£	s.	d.
Page 1	1003	3	0	10	0	0
,, 2	1080	0	0			
,, 3	1665	0	0			
,, 4	2050	0	0			
,, 5	1160	0	0			
Total . . . £	6958	3	0	10	0	0

SCHEDULE III

Fo.		Dr. Total £	s.	d.	Cr. Total £	s.	d.	Dr. Balance £	s.	d.	Cr. Balance £	s.	d.
1	Andrew, P. . . .	1000	0	0	500	0	0	500	0	0			
	Allison, G. . . .	500	0	0	480	0	0	20	0	0			
	Bedells, F. . . .	290	0	0	300	0	0				10	0	0
		1790	0	0	1280	0	0	£520	0	0	£10	0	0
		10	0	0	520	0	0						
	£	1800	0	0	1800	0	0						

If the working out of the balances and the castings of both the totals and the balances be right, then, if the total credit balances be added to the debit totals, the result must agree with the total of the debit balances added to the credit totals, as shown in the *pro forma* schedule. This method of extracting Ledger totals and then working out the balances is, in practice, the quickest method of all, and saves much time which would otherwise be spent on the Ledger, if only in altering and rubbing out figures, for where it is adopted the balances are only brought down in the Ledgers after they have been agreed.

The calling of postings and checking of additions may be done weekly, fortnightly, monthly, or quarterly, or otherwise, according to circumstances. Where the checking of postings is done at intervals before the close of the year, the clerks must be enjoined not under any circumstances to alter any figure which has been ticked, but to make an adjusting entry instead. In no case should erasures be permitted. In cases where there are many books or much detail, a Summary of Postings (*vide* illustration, Schedule IV) should be prepared, so that each Ledger or class of Ledgers may be agreed independently. By this means differences are localized and more easily detected.

It will be observed that the Summary of Postings is in the form of a Ledger Account, of which the debits and credits are the aggregated totals of the debits and credits of the individual Ledger Accounts. It therefore follows that unless the books themselves are correct as to postings and castings, the total postings correctly summarized and the balances correctly extracted, the debit and credit totals in the Summary of Postings will not correspond. If they do correspond, the arithmetical accuracy of the books is proved.

The Summary of Postings itself can only be prepared after the close of the year. The monthly totals in the subsidiary Summaries should be inserted as soon as the checking of the figures for the month has been completed and the totals in the original books inked in.

Sometimes it happens that, even after all the figures have been ticked off, the totals in the Summary do not correspond. Before re-checking, the expert will try to "spot" the difference. By exercising a little ingenuity this may often be done without the labour which re-checking all the figures would involve. The first thing to do is to "diagnose" the difference. Is there "too much debit" or "too much credit"? If the former, see, in the first place, whether a credit balance has been omitted, or a credit balance taken down as a debtor, or a credit posting overlooked. And, in fact, exhaust the credit side before examining the debtor side. If there be "too much credit," then the process should be

SCHEDULE IV

SUMMARY OF POSTINGS, 31st December, 19..

Debits

Description	Per page	Cash Book £	s.	d.	Private Ledger £	s.	d.	Bought Ledger £	s.	d.	Sales Ledger £	s.	d.	Dr. Total £	s.	d.
Dr. Balances @ 1/1/.. per Summary of Balances		100	0	0	5,000	0	0	10	0	0	6,000	0	0	11,110	0	0
Sales	1							170	0	0	20,230	0	0	20,400	0	0
Sold Returns	2				55	0	0							55	0	0
Purchases	3				10,750	0	0							10,750	0	0
Bought Returns	4							62	0	0	3	0	0	65	0	0
Cash Received	5	11,900	0	0										11,900	0	0
Cash Paid	,,				3,850	0	0	7,748	0	0	2	0	0	11,600	0	0
Discounts Allowed	6				223	0	0							223	0	0
Discounts Received	7							259	19	0		1	0	260	0	0
Bills Receivable	8				7,100	0	0							7,100	0	0
Bills Payable	9							1,160	0	0				1,160	0	0
Journal	10				5,035	0	0	60	0	0	5	0	0	5,100	0	0
Cr. Balances @ 31/12/.. per Summary of Balances					11,000	0	0	2,276	3	0	10	0	0	13,286	3	0
£		12,000	0	0	43,013	0	0	11,746	2	0	26,250	1	0	93,009	3	0

Credits

Description	Per page	Cr. Total £	s.	d.	Cash Book £	s.	d.	Private Ledger £	s.	d.	Bought Ledger £	s.	d.	Sales Ledger £	s.	d.
Cr. Balances @ 1/1/.. per Summary of Balances		11,110	0	0				10,000	0	0	1,100	0	0	10	0	0
Sales	1	20,400	0	0				20,400	0	0						
Sold Returns	2	55	0	0							6	0	0	49	0	0
Purchases	3	10,750	0	0							10,600	0	0	150	0	0
Bought Returns	4	65	0	0				65	0	0						
Cash Received	5	11,900	0	0				295	0	0	10	0	0	11,595	0	0
Cash Paid	6	11,600	0	0	11,600	0	0									
Discounts Allowed	,,	223	0	0								2	0	222	18	0
Discounts Received	7	260	0	0				260	0	0						
Bills Receivable	8	7,100	0	0										7,100	0	0
Bills Payable	9	1,160	0	0				1,160	0	0						
Journal	10	5,100	0	0				4,925	0	0	10	0	0	165	0	0
Dr. Balances @ 31/12/.. per Summary of Balances		13,286	3	0	400	0	0	5,908	0	0	20	0	0	6,958	3	0
£		93,009	3	0	12,000	0	0	43,013	0	0	11,746	2	0	26,250	1	0

Note. In Schedule No. II the Sales Ledger Balances are shown by way of illustration.

reversed, subject to the proviso that as the credit side is generally the shorter of the two, it should, as a rule, be dealt with in the first place. Sometimes the amount of the difference is in itself suggestive. For example, to take a simple illustration, a difference of £9 10s. may be £10 posted as 10s., and one would look up all the items of £10. But, if more debit is wanted, it would obviously be absurd to look for a credit of £10 posted as 10s. If the difference be an even figure, say £12 10s., it may be £6 5s. posted on the wrong side of the Ledger, or a balance taken out on the wrong side.

Ledger Accounts which have been squared off or in which the balance has been paid or received are not likely to be wrong, nor are Bought Ledger Accounts which have been agreed with the monthly statements received from the creditor. The casts of a Cash Book the balance of which has been agreed with the cash on hand or with the Bank Pass-book (duly verified) can hardly be wrong. The balance of Bills Receivable Account should be agreed with the bills on hand, as shown by the Bills Receivable Book; the balance of bills payable with the bills not due, as shown by the Bills Payable Book. This demonstrates the accuracy of the Bills Receivable and Bills Payable Accounts. The entries relating to discounts and allowances should be carefully re-checked, as to both postings and castings. These items are more frequently altered than any others in commercial books, even after the checking has been completed. Figures, if any, which have been altered or erased should be re-checked in the first instance. One should also see that items belonging to the next year have not been ticked either in the Ledgers or the subsidiary books, and so brought into account. The change of colour each year facilitates the detection of such errors, which, otherwise, might be overlooked again and again. If the difference be one of pence, before checking the postings, the castings of the pence columns throughout the books should be quickly re-checked. This can be done much more rapidly than re-checking postings, and that source of error should, therefore, be eliminated first—the principle in looking for a difference being to do in the first place that which takes the least time. By these means the area of search is narrowed down with the least loss of time until the difference is discovered. If, however, the whole of the books have to be re-checked, the "ticks" should be in a different colour from those which were used previously, or in the preceding year.

It would be easy to add many other suggestions, but the reader will readily think out ideas for himself, and the more he does so, the more expert and resourceful will he become in agreeing books "to a penny." Books carefully kept and carefully checked in a methodical way should, however, be agreed "to a penny" very quickly, and the preparation of a summary of postings in the manner described encourages method and accuracy besides fixing the responsibility for errors.

Books may also be agreed by totals instead of by balances. Where this is done the total debits and credits have to be extracted from the Ledgers. This has the advantage that each side of the Ledgers may be agreed separately. In fact, one may go still further, and divide the debits and credits into cash, sales, and so forth, and agree each section of totals separately.

CASH DISCOUNTS RECEIVED (PER CASH BOOK)

	C.B. Fo.	Bought Ledger Dr.			Sales Ledger Dr.			Private Ledger Cr.		
19..		£	*s.*	*d.*	£	*s.*	*d.*	£	*s.*	*d.*
January		10	0	0				10	0	0
February		20	0	0				20	0	0
March		30	0	0				30	0	0
April		40	0	0				40	0	0
May		25	0	0				25	0	0
June		35	0	0				35	0	0
July		20	0	0				20	0	0
August		10	0	0				10	0	0
September		30	0	0				30	0	0
October		15	0	0				15	0	0
November		9	19	0		1	0	10	0	0
December		15	0	0				15	0	0
Totals to Summary . £		259	19	0		1	0	260	0	0

BILLS RECEIVABLE (PER BILLS RECEIVABLE BOOK)

	Fo.	Private Ledger Dr.			Sales Ledger Cr.		
19..		£	*s.*	*d.*	£	*s.*	*d.*
January		1000	0	0	1000	0	0
February		500	0	0	500	0	0
March		800	0	0	800	0	0
April		900	0	0	900	0	0
May		300	0	0	300	0	0
June		500	0	0	500	0	0
July		800	0	0	800	0	0
August		200	0	0	200	0	0
September		600	0	0	600	0	0
October		500	0	0	500	0	0
November		400	0	0	400	0	0
December		600	0	0	600	0	0
Totals to Summary . £		7100	0	0	7100	0	0

BILLS PAYABLE (PER BILLS PAYABLE BOOK)

	Fo.	Bought Ledger Dr.			Private Ledger Cr.		
19..		£	s.	d.	£	s.	d.
January		100	0	0	100	0	0
February		50	0	0	50	0	0
March		60	0	0	60	0	0
April		—	—	—	—	—	—
May		100	0	0	100	0	0
June		—	—	—	—	—	—
July		200	0	0	200	0	0
August		100	0	0	100	0	0
September		—	—	—	—	—	—
October		50	0	0	50	0	0
November		200	0	0	200	0	0
December		300	0	0	300	0	0
Totals to Summary . £		1160	0	0	1160	0	0

JOURNAL

	Fo.	Debits: Private Ledger			Debits: Sales Ledger			Debits: Bought Ledger			Total			Credits: Private Ledger			Credits: Sales Ledger			Credits: Bought Ledger		
19..		£	s.	d.	£	s.	d.	£	s.	d.	£	s.	d.	£	s.	d.	£	s.	d.	£	s.	d.
Jan.		10	0	0	5	0	0				15	0	0	5	0	0				10	0	0
Feb.																						
March		5	0	0							5	0	0				5	0	0			
April																						
May								10	0	0	10	0	0	10	0	0						
June																						
July																						
August		20	0	0				10	0	0	30	0	0	10	0	0	20	0	0			
Sept.																						
Oct.																						
Nov.																						
Dec.		5000	0	0				40	0	0	5040	0	0	4900	0	0	140	0	0			
Totals to Summary	£	5035	0	0	5	0	0	60	0	0	5100	0	0	4925	0	0	165	0	0	10	0	0

SALES (PER DAY BOOKS)

	Fo.	Town Day Book I			Fo.	Country Day Book III			Sales Ledger Dr.			Bought Ledger Dr.			Private Ledger Cr.	
19..		£	s.	d.		£	s.	d.	£	s.	d.	£	s.	d.	£	s.
January	4	1400	0	0	2	100	0	0	1500	0	0				1500	0
February	7	1500	0	0	4	200	0	0	1700	0	0				1700	0
March	11	1300	0	0	6	300	0	0	1600	0	0				1600	0
April	14	1200	0	0	8	300	0	0	1450	0	0	50	0	0	1500	0
May	18	1600	0	0	10	200	0	0	1780	0	0	20	0	0	1800	0
June	22	1400	0	0	14	500	0	0	1900	0	0				1900	0
July	26	1800	0	0	16	100	0	0	1870	0	0	30	0	0	1900	0
August	30	1400	0	0	18	200	0	0	1600	0	0				1600	0
September	34	1500	0	0	21	300	0	0	1800	0	0				1800	0
October	38	1600	0	0	22	100	0	0	1700	0	0				1700	0
November	43	1600	0	0	25	300	0	0	1900	0	0				1900	0
December	45	1200	0	0	28	300	0	0	1430	0	0	70	0	0	1500	0
Totals to Summary £									20,230	0	0	170	0	0	20,400	0

SOLD RETURNS (PER SOLD RETURNS BOOK)

	Fo.	Private Ledger Dr. £	s.	d.	Sales Ledger Cr. £	s.	d.	Bought Ledger Cr. £	s.	d.
19..										
January	1	12	0	0	10	0	0	2	0	0
February	2	14	0	0	14	0	0			
March	3	5	0	0	4	0	0	1	0	0
April	4									
May	5	1	0	0	1	0	0			
June	6									
July	7	10	0	0	8	0	0	2	0	0
August	8	2	0	0	2	0	0			
September	9	4	0	0	4	0	0			
October	10									
November	11	5	0	0	4	0	0	1	0	0
December	12	2	0	0	2	0	0			
Totals to Summary £		55	0	0	49	0	0	6	0	0

PURCHASES (PER BOUGHT DAY BOOK)

	Fo.	Private Ledger Dr. £	s.	d.	Bought Ledger Cr. £	s.	d.	Sales Ledger Cr. £	s.	d.
19..										
January		650	0	0	600	0	0	50	0	0
February		300	0	0	300	0	0			
March		1,800	0	0	1,800	0	0			
April		400	0	0	400	0	0			
May		700	0	0	600	0	0	100	0	0
June		1,400	0	0	1,400	0	0			
July		500	0	0	500	0	0			
August		800	0	0	800	0	0			
September		1,600	0	0	1,600	0	0			
October		500	0	0	500	0	0			
November		1,500	0	0	1,500	0	0			
December		600	0	0	600	0	0			
Totals to Summary £		10,750	0	0	10,600	0	0	150	0	0

CASH BOOK

	Fo.	Cr. Private Ledger			Cr. Bought Ledger			Cr. Sales Ledger			Cash Received — Total Debit			Cash Paid — Total Credit			Dr. Private Ledger			Dr. Bought Ledger			Dr. Sales Ledger		
		£	s.	d.	£	s.	d.	£	s.	d.	£	s.	d.	£	s.	d.	£	s.	d.	£	s.	d.	£	s.	d.
Balance, 1st Jan., 19.. .											100	0	0												
January ,, .		50	0	0				450	0	0	500	0	0	400	0	0	300	0	0	100	0	0			
February ,, .		30	0	0	10	0	0	1,360	0	0	1,400	0	0	800	0	0	400	0	0	400	0	0			
March ,, .		20	0	0				1,580	0	0	1,600	0	0	1,200	0	0	500	0	0	700	0	0			
April ,, .		10	0	0				1,490	0	0	1,500	0	0	1,400	0	0	200	0	0	1,200	0	0			
May ,, .		50	0	0				1,350	0	0	1,400	0	0	1,500	0	0	500	0	0	1,000	0	0			
June ,, .		20	0	0				1,580	0	0	1,600	0	0	1,400	0	0	200	0	0	1,200	0	0			
July ,, .		10	0	0				1,390	0	0	1,400	0	0	1,200	0	0	500	0	0	700	0	0			
August ,, .		10	0	0				390	0	0	400	0	0	800	0	0	100	0	0	700	0	0			
September ,, .		20	0	0				280	0	0	300	0	0	1,100	0	0	400	0	0	700	0	0			
October ,, .		30	0	0				770	0	0	800	0	0	600	0	0	200	0	0	400	0	0			
November ,, .		40	0	0				560	0	0	600	0	0	500	0	0	250	0	0	248	0	0	2	0	0
December ,, .		5	0	0				395	0	0	400	0	0	700	0	0	300	0	0	400	0	0			
Balance, 31st Dec., 19.. .														400	0	0									
											12,000	0	0	12,000	0	0									
Less Cash Balances at 1st Jan. and 31st Dec., 19..											100	0	0	400	0	0									
Totals to Summary . £		295	0	0	10	0	0	11,595	0	0	11,900	0	0	11,600	0	0	3,850	0	0	7,748	0	0	2	0	0

BOUGHT RETURNS (PER BOUGHT RETURNS BOOK)

	Fo.	Bought Ledger Dr.			Sales Ledger Dr.			Private Ledger Cr.		
19..		£	s.	d.	£	s.	d.	£	s.	d.
January		10	0	0				10	0	0
February		5	0	0	1	0	0	6	0	0
March		6	0	0				6	0	0
April		4	0	0				4	0	0
May										
June		10	0	0	2	0	0	12	0	0
July		2	0	0				2	0	0
August		4	0	0				4	0	0
September		6	0	0				6	0	0
October		8	0	0				8	0	0
November		4	0	0				4	0	0
December		3	0	0				3	0	0
Totals to Summary . £		62	0	0	3	0	0	65	0	0

CASH DISCOUNTS ALLOWED (PER CASH BOOK)

	C.B. Fo.	Private Ledger Dr.			Sales Ledger Cr.			Bought Ledger Cr.		
19..		£	s.	d.	£	s.	d.	£	s.	d.
January		10	0	0	10	0	0			
February		25	0	0	24	18	0		2	0
March		30	0	0	30	0	0			
April		25	0	0	25	0	0			
May		30	0	0	30	0	0			
June		25	0	0	25	0	0			
July		28	0	0	28	0	0			
August		8	0	0	8	0	0			
September		6	0	0	6	0	0			
October		16	0	0	16	0	0			
November		12	0	0	12	0	0			
December		8	0	0	8	0	0			
Totals to Summary . £		223	0	0	222	18	0		2	0

APPENDIX

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WEAR AND TEAR ALLOWANCES

THE FOLLOWING IS THE COMPLETE SCHEDULE OF AGREED RATES OF DEPRECIATION FOR THE PURPOSE OF COMPUTING LIABILITY TO UNITED KINGDOM INCOME TAX

A. General Notes

1. Except in the cases of (*a*) shipping, and (*b*) tramways, all allowances are calculated on a written down value deemed to be that as at the commencement of the year of assessment.

2. All additions to, and renewals and replacements of, plant and machinery in respect of which an allowance for wear and tear is made are treated as a capital outlay, except that renewals and replacements of parts of a machine which do not destroy its identity are allowed as a business expense.

3. A claim for an increased rate of allowance on the ground of the use of the machinery or plant over and above that by reference to which the estimated life has been computed is considered in the light of the circumstances of each individual case.

4. The additional deduction of one-tenth of the deduction in respect of wear and tear, granted by Section 18 of the Finance Act, 1932, is not included in the figures in the schedule.

B. Rates for Particular Industries

	Per cent.
BAKERY	
Plant and machinery generally	8
(No allowance is made in respect of brick, stone or other non-metal parts of the structure of ovens, but the cost of repairs, replacements and rebuilding is allowed as a charge against revenue as and when incurred. The cost of additional ovens and extensions to, and enlargements of, existing ovens is treated as capital expenditure.)	
BLEACHING AND FINISHING	
Plant and machinery generally	7½
BOOKBINDING	
Engines, boilers and shafting	5
General binding machinery	7½
BRASSFOUNDING	
Engines, boilers and shafting	5
Electric motors, dynamos and other electrical plant	7½
Other plant and machinery	7
BRICK-MAKING	
Steam engines, boilers and shafting and mixing and brick-making machines	5
Electrical plant (dynamos, motors, transformers, &c.)	7½
Crushing and grinding plant	7½
(No allowance is made in respect of kilns but the cost of repairs and renewals and rebuilding is allowed as a charge against revenue: the cost of new kilns and of extensions to existing kilns, is treated as capital expenditure in the ordinary course.)	
CHEMICAL MANUFACTURE	
Chemical plant other than sulphuric acid plant	7½
Electrical plant	7½
Other plant	5

	Per cent.
Clothing—Heavy (Men's)	
All plant and machinery	9
Clothing—Light (Ladies' and Children's)	
Engines, boilers and shafting	5
Electric motors	7½
General machinery (process plant)	10
Collieries	
Railway wagons	6¼
Surface plant and machinery, other than electrical plant	6¼
Electrical plant at the surface and all underground plant installed in the shaft pillar	7½
Other underground plant	10
Steam lorries	15
Lorries driven by internal combustion engines	20
Corset Manufacture	
Engines, boilers and shafting	5
Laundry and cutting machinery	7½
Electric motors	7½
Other machinery	10
Motor vans	20
Creameries, Dairies and Ice Cream Factories	
Steam boilers, steam and gas engines and storage tanks	5
Refrigerating plant (except iceless cabinets) and bottling and washing machines	10
Iceless cabinets	15
Other plant and machinery, including electric motors	7½
(Loose plant, box cycles, utensils (churns, bottles, &c.), and piping are dealt with on renewals basis.)	
Crochet Hook Manufacture	
Engines, boilers and shafting	5
Other machinery	6
Electric motors	7½
Cutlery Blanks, Goffing, Forging and Stamping of	
Electric motors, grinding machines, drop hammers, goff hammers and power stamps	7½
All other plant and machinery	5
(No allowance is made in respect of grinding and other wheels, utensils, belting, electric cables or furnaces but the cost of repairs and replacements is allowed as a charge against revenue: the cost of additions to or enlargement of such wheels, utensils, belting cables or furnaces is treated as capital expenditure in the ordinary course.)	
Cutlery Manufacture	
Electric motors, knife-grinding machines, drop hammers, power hammers, power stamps and buffing and glazing machines	7½
All other plant and machinery	5
(No allowance is made in respect of emery, glazing and other wheels or in respect of utensils, belting, electric cables or furnaces, but the cost of repairs and replacement is allowed as a charge against revenue: the cost of additions to or enlargement of such wheels, utensils, belting, cables or furnaces is treated as capital expenditure in the ordinary course. In the application of General Note 2 above, each of the constituent parts of a cutler's frame (e.g. beams, brackets, shafting and pulleys) is treated as a separate machine.)	
Drop Forgings Manufacture	
Plant and machinery generally, including that in the tool and die shops	7½
(No allowance is made in respect of furnaces, but the cost of repairs	

	Per cent.
and renewals and rebuilding is allowed as a charge against revenue: the cost of additional furnaces and of extensions to existing furnaces is treated as capital expenditure in the ordinary course.)	
Dyeing and Cleaning	
Plant and machinery generally	7½
Motor Vans	20
Dyeing and Finishing	
Plant and machinery generally	7½
Dyestuffs (Synthetic) Manufacture	
Locomotives	4
Railway wagons (ordinary)	5
Boilers, steam engines and shafting	5
Coal-handling plant and feed pumps	5
Rails of railway sidings	6
Electric motors and dynamos	7½
Ice-making plant (excluding any steam power plant)	7½
Open railway wagons used exclusively for conveyance of specially deleterious substances	7½
All other plant and machinery	15

(No allowance is made in respect of:—
(a) Nitric acid plant or plant consisting of glass, silica or other similar material as distinct from metal;
(b) pipes and electric cables;
(c) railway sidings, except the rails: but the cost of repairs and reinstatement is allowed as a charge against revenue.
For the purposes of the exception mentioned in General Note 2 above, each of the constituent parts (e.g. vats, autoclaves, &c.), of a battery constituting a single unit, and each rail of the railway sidings, is considered as a separate machine.)

Electricity Undertakings	
Cables (including cost of laying)	3
Meters	7½
Plant other than cables, and exclusive of loose tools, meters, office furniture	5
Domestic electrical appliances, cookers and kettles	20
Refrigerators, washing machines, washing boilers and water heaters	15
Other kinds of apparatus	10

(No allowance is made in respect of conduits, loose tools and office furniture, but annual expenditure on repairs and renewals is allowed as a charge against revenue.)

Embroidery Manufacture	
Plant and machinery generally	7½
Engineers' Precision Tools Manufacture	
Steam and gas engines, boilers, shafting and pulleys	5
Electric machinery, including dynamos and motors	7½
Other plant and machinery	9

(These rates apply to plant and machinery employed in the manufacture of, e.g., twist drills, milling cutters, reamers, tap dies and screwing tackle.)

Envelope Making	
Steam power plant and shafting	5
Electrical power plant, including dynamos and motors	7½
All machinery used for the purpose of making envelopes	7½
Motor lorries and motor vans	20

	Per cent.
FARMING	
Steam boilers and engines, portable steam engines, threshing machines and fixed plant	5
Electric installations	7½
Petrol or oil driven tractor-cultivators	22½
Steam lorries	15
Motor lorries and vans driven by internal combustion engines	20
All other types of farm machinery and implements, including portable poultry (and similar) sheds and incubators	10

(No allowance is made in respect of minor loose plant and utensils, but the cost of renewals is allowed as a charge against revenue. Allowance is granted in respect of motor cars used for business purposes at the same rate as for motor lorries, restricted, however, to the proportionate part applicable to such use.)

FILE AND RASP MANUFACTURE	
Electric motors, grinding machines, drop hammers, goff hammers and power stamps	7½
File cutting and rasp punching machines	6¼
All other plant and machinery	5

(No allowance is made in respect of grinding and other wheels, utensils, belting, electric cables or furnaces, but the cost of repairs and replacements is allowed as a charge against revenue: the cost of additions to or enlargements of such wheels, utensils, belting, cables, or furnaces is treated as capital expenditure in the ordinary course.)

FISHING TACKLE MANUFACTURE	
Engines, boilers and shafting	5
Fishing hook and rod making machinery	6
Electric motors	7½
FLAX SPINNING AND LINEN WEAVING	
Plant and machinery generally	7½

(No allowance is made in respect of accessory plant such as pirns, pirn cages, spools, belting, driving ropes, damask cards, designs, patterns, models, furniture and fixtures.)

FLOCK MANUFACTURE	
Motive plant and machinery (steam or water)	5
Other plant and machinery	7½
FLOUR MILLING	
Steam power plant and shafting	5
Electric motors and other electric plant, gas and oil engines, other than Diesel type engines, roller mills, automatic weighers, elevators and conveyors (with legging) and spouting	7½
Other plant and machinery, including Diesel type engines	10
FURNITURE MANUFACTURE	
Engines, boilers and shafting	5
General plant and machinery	7½
Electric motors	7½
Steam wagons and lorries	15
Motor wagons and lorries driven by internal combustion engines	20

GAS UNDERTAKINGS (WORKED BY LOCAL AUTHORITIES)

(No allowance is given, but all expenditure on repairs and renewals (excluding extensions and improvements) is allowed as a charge against revenue.)

GAS UNDERTAKINGS (OTHER THAN THOSE OWNED BY LOCAL AUTHORITIES)	
Gasholders (not including tanks, except where constructed of steel or iron). The cost of excavation is not allowed to be included in the value upon which the allowance is computed	3

	Per cent.
Meters (ordinary and prepayment), cookers, and gas fires	10

(No allowance is given in respect of other plant and machinery, but expenditure on repairs and renewals is allowed as a charge against revenue.)

HANDKERCHIEF AND EMBROIDERY MANUFACTURE

Engines, boilers, shafting and gearing, and motors	5
Stitching machines	10

HEMSTITCHING

Engines, boilers, shafting and gearing and motors	5
Hemstitching machines	10

HOSIERY MANUFACTURE

Steam engines, boilers, and shafting	5
Manufacturing machinery (process plant)	13
Electric motors	7½

HOSIERY NEEDLE MANUFACTURE

Steam and gas engines, boilers and shafting	5
Electric motors	7½
Process (or manufacturing) machinery	10

ICE MANUFACTURE AND COLD STORES

Steam and gas engines, boilers and shafting	5
Electric plant and insulation	7½
Refrigerating machinery, i.e. compressors, condensors, ice tanks, coolers, conduits, moulds, coils, travellers, &c.	10

(No allowance is made in respect of lagging, belting, loose plant, utensils, &c., but the cost of renewals and replacements is allowed as a charge against revenue.)

LACE AND EMBROIDERY MANUFACTURE

Plant and machinery generally	7½

LINOLEUM AND FLOOR CLOTH MANUFACTURE

Engines, boilers and shafting	5
Other plant	7½
Diesel engines	10

LOCOMOTIVE MANUFACTURE

Boilers, engines, shafting and slow-moving plant and machinery	5
Electric motors, dynamos, and other electric plant; high speed metal working machinery, viz. lathes, drilling, milling, planing, shaping and similar machines	7½

(No allowance is made in respect of furnaces, but the cost of repairs and replacements and rebuilding is allowed as a charge against revenue: the cost of additional furnaces and extension to existing furnaces is treated as capital expenditure in the ordinary course.)

MACHINE TOOL MANUFACTURE

Steam engines, boilers and shafting	5
Other plant and machinery, including electrical	7½

(The agreement does not apply to grinding and other similar machinery. No allowance is made in respect of furnaces, but the cost of repairs and replacements and rebuilding is allowed as a charge against revenue: the cost of additional furnaces and of extensions to existing furnaces is treated as capital expenditure in the ordinary course.)

MADRAS MANUFACTURE

Plant and machinery generally	7½

	Per cent.
MANTLES AND LADIES' CLOTHING	
Engines, boilers and shafting	5
Electric motors	7½
General machinery (process plant)	10
MATCH MANUFACTURE	
Steam engines, boilers and shafting	5
Lathes, wood-cutting and wax taper making machinery, including taper drums	5
General plant and machinery, including electric dynamos and motors, match making, splint levelling and cleaning and box-filling machines	7½
Motor lorries and motor vans	20
(For the purpose of General Note 2 above, a complete match chain is to be treated as a complete machine and not as part of a machine.)	
MOTOR VEHICLES WITH INTERNAL COMBUSTION ENGINES, MANUFACTURE OF	
Steam engines, boilers and shafting	5
Fast running precision plant employed solely and directly in the production to absolute accuracy of parts of motor vehicles	12½
Fast running plant not within the foregoing definition, other manufacturing plant and machinery, and electric motors	7½
Accounting, calculating and other similar office appliances	10
NAIL MANUFACTURE	
Plant and machinery generally	5
NEEDLE MANUFACTURE	
Engines, boilers and shafting	5
Needlemaking machinery and electric motors	7½
NEWSPAPER PRINTING	
Engines, boilers and shafting	5
Printing machines	7½
Type	10
(Normally no allowance is given in respect of type, but the actual cost of renewals is allowed as a charge against revenue.)	
PAINT, COLOUR AND VARNISH MANUFACTURE	
Engines, boilers, shafting and storage tanks	5
General plant and machinery, including grinding machinery, and electric motors	7½
Motor lorries and motor tractors	20
(No allowance is made in respect of horses, loose tools or utensils, including typewriters. The above rates do not apply to ore crushing machinery.)	
PAPER BAG MANUFACTURE	
Engines, boilers and shafting	5
General plant and machinery, and electric motors	7½
Motor vans	20
PAPER BOX MANUFACTURE	
Plant and machinery generally	7½
Motor vans	20
PAPER MILLS	
Machinery working by day only	5
Machinery working day and night	7½
(Paper-making is a continuous process. A number of machines, each dealing with a stage of manufacture, are linked up to form one	

Per cent.

productive unit. For the purpose of General Note 2 above, each machine is treated as a separate item of plant and not as a part.)

Pig Iron and Steel Manufacture

	Per cent.
Plant and machinery generally, including machinery ancillary to furnaces	7½

(No allowance is made in respect of the structure of furnaces of any kind (whether known as furnaces, calcining kilns, hot blast stoves, steel mixers, soaking pits, regenerative furnaces, or by any other name), but the cost of repairs and replacements and rebuilding is allowed as a charge against revenue: the cost of additional furnaces and of all extensions and enlargements of existing furnaces is treated as capital expenditure in the ordinary course.)

The rate applies only to concerns engaged in the production of pig iron, or, *inter alia*, of heavy steel ingots of a weight not less than half a ton, and to certain steel-rolling, forging, hammering and steel re-rolling concerns.

Printing

	Per cent.
Engines, boilers and shafting	5
Printing and binding machines	7½
Type	10

(Normally no allowance is given in respect of type but the actual cost of renewals is allowed as a charge against revenue.)

Shipping

1. In the case of a new ship, the allowance (other than that for refrigerating plant and insulation) is computed on the following basis:—

(a) sailing vessels	3 per cent on prime cost.
(b) steamers and motor vessels—	
(i) delivered before 1917 or after 1922	4 per cent. on prime cost.
(ii) delivered during the period 1917–1922	one twenty-fourth of the difference between prime cost and break-up value.
(c) tankers	5 per cent. on prime cost.

"Prime cost" means the cost price of the vessel, exclusive of the portion relating to refrigerating plant and insulation. As to subsequent capital expenditure, see paragraph 3 below.

2. The break-up value of the vessel, exclusive of the refrigerating plant and insulation, is computed on the basis of a percentage of prime cost:—

	Per cent.
(a) sailing vessels	3
(b) steamers and motor vessels—	
(i) delivered before 1917 or after 1922	4
(ii) delivered in—	
1917	3
1918	2
1919	1½
1920	1½
1921	2½
1922	3
(c) tankers	5

The break-up value, as computed above, remains constant throughout the life of the ship, i.e. it is not affected by capital expenditure or by the sale of the ship.

3. Any expenditure which has been treated as capital for tax purposes (e.g. renewal of engines and boilers, or structural improvements) is added to the prime cost of the ship for the purpose of computing the aggregate allowance to be made.

As regards sailing vessels, steamers and motor vessels, the annual allowance in respect of such expenditure is computed as follows:—

(*a*) where the expenditure is incurred before the expiration of 20 years of the life of the ship, the normal allowance is increased by such a sum as will exhaust the expenditure over the remainder of the period for which the normal allowance will require to be made;

(*b*) where the expenditure is incurred after the expiration of 20 years of the life of the ship the normal allowance is increased by the fractional part of the expenditure given in the third column of the table in paragraph 8 below, substituting the age of the ship when the expenditure was incurred for the "age at date of purchase."

4. The allowance in respect of refrigerating plant and insulation, except in so far as acquired with a second-hand ship (see paragraph 7), is computed separately from the allowance for the hull, &c., in order to ensure that:—

(*a*) the allowance ceases when the break-up value of the plant, &c., is reached, and

(*b*) the aggregate allowance does not exceed the cost to the owner less the break-up value.

5. The basis for computation of the allowance in respect of the original refrigerating plant, &c., is 6¼ per cent. (or 5¼ per cent. in the case of sailing vessels) on the cost.

A similar allowance is made in respect of plant added to a ship (other than additions effected in the years 1917 to 1922) or for capital expenditure incurred in connection with existing plant. Where, however, the basis given in paragraph 3 is more favourable to the owner, that basis is applied, but the break-up value is computed as indicated in paragraph 6.

The allowance in respect of plant installed on a steamer or motor vessel, and delivered in one of the years 1917 to 1922, is computed on the basis of one twenty-fourth of the difference between cost and break-up value, plus 2½ per cent. on the cost.

6. The break-up value is computed at the rates given in paragraph 2. In the case of steamers and motor vessels equipped with refrigerating plant, &c., after the date of delivery of the ship, the rate applied is that appropriate to the year of re-delivery.

The break-up value is revised on the occasion of each extension of the existing plant, but no revision is made on account of capital expenditure on the renewal or improvement of existing plant.

7. The allowance in respect of a ship purchased second-hand is computed by reference to:—

(*a*) the actual cost of the ship to the new owner less the break-up value (i.e. the aggregate of the existing break-up values of the hull, &c., and refrigerating plant, &c.), and

(*b*) the reasonable expectation of life of the ship at the date of purchase (see paragraphs 8 and 9).

Allowances for the hull, &c., and for refrigerating plant, &c., acquired with the ship are not separately computed.

Allowances for subsequent capital expenditure on refrigerating plant, &c., and break-up values for extension to such plant, are separately computed on the bases given in paragraphs 5 and 6 respectively. Other capital expenditure is to be dealt with as indicated in paragraph 3.

8. As regards steamers and motor vessels, the following scale is applied, except where a vessel is over 30 years old at the date of purchase; such vessels are to be dealt with according to the facts of each case.

Age at Date of Purchase	Expectation of Life after Deducting One Year	Fractional Part of Cost less Break-up Value to be Written off each Year for Wear and Tear
Years	Years	
0	24	$\frac{1}{24}$
1	23	$\frac{1}{23}$
2	22	$\frac{1}{22}$
3	21	$\frac{1}{21}$
4	20	$\frac{1}{20}$
5	19	$\frac{1}{19}$
6	18	$\frac{1}{18}$
7	17	$\frac{1}{17}$
8	16	$\frac{1}{16}$
9	15	$\frac{1}{15}$
10	14	$\frac{1}{14}$
11	13	$\frac{1}{13}$
12	12	$\frac{1}{12}$
13	11	$\frac{1}{11}$
14	10	$\frac{1}{10}$
15	10	$\frac{1}{10}$
16	10	$\frac{1}{10}$
17	10	$\frac{1}{10}$
18	9	$\frac{1}{9}$
19	9	$\frac{1}{9}$
20	9	$\frac{1}{9}$
21	8	$\frac{1}{8}$
22	8	$\frac{1}{8}$
23	7	$\frac{1}{7}$
24	6	$\frac{1}{6}$
25	6	$\frac{1}{6}$
26	5	$\frac{1}{5}$
27	5	$\frac{1}{5}$
28	4	$\frac{1}{4}$
29	4	$\frac{1}{4}$

9. The expectation of life of vessels other than steamers and motor vessels is determined by reference to the particular facts in each case.

	Per cent.
SHOE AND SLIPPER MANUFACTURE	
Engines, boilers and shafting	5
Manufacturing machinery (process plant)	10
Motor vans and motor lorries	20
SILK MANUFACTURE	
Steam engines, boilers and shafting	5
General plant and machinery (including winding, throwing, doubling and weaving machinery) and electric motors	$7\frac{1}{2}$
Sewing braiding, and knitting machinery	10

(The allowances are applicable to plant and machinery used in the manufacture of natural or artificial silk materials, including materials consisting partly of silk and partly of wool and/or cotton.)

STEAM LAUNDRY PROPRIETORS	
Plant and machinery generally	$7\frac{1}{2}$
Motor vans	20

	Per cent.
Sulphuric Acid Manufacture	
Chamber Process	
Nitre plant, ammonia, oxidation plant, towers and plant used in connection therewith, chambers and incidental plant, chimney stack, dearsenicating plant, concentrating plant	15
Contact Process	
Towers, blower, grease separating and pressure balancing chambers, heat interchangers, pre-heaters, super-heaters, converters and contact mass, absorption vessels, weighing tanks and machine plant for platinization and revivification of contact mass	15
Either Process	
Plant for dealing with sulphur raw material, mechanical and hand burners, power plant, acid eggs, storage tanks, cisterns and connections, fans, pumps, railway tank wagons	15
Timber Merchants, Saw Millers, and Timber Goods Manufacture	
Engines, boilers and main shafting	5
General saw-milling plant and machinery	7½
Traction engines, tractors, motor cars and haulage plant	20

Tramways and Light Railways

The following is an extract from the agreed scheme which is generally applied.

Permanent Way

(Annual allowances are granted in respect of the depreciation by wear and tear of the permanent way equal to the cost of the track divided by the number of years of its estimated life.)

. . . .

3. The life of the permanent way is, normally, to be taken as 12, 14 or 16 years, according to the traffic thereon. The classification is to be based on the average car mileage per mile of track per annum of the financial year preceding the year of assessment, viz. :—

(i) not exceeding 50,000 car miles per mile of track—16 years;
(ii) over 50,000 and not exceeding 75,000 car miles per mile of track—14 years;
(iii) over 75,000 and not exceeding 125,000 car miles per mile of track—12 years;
(iv) over 125,000 car miles per mile of track—special consideration.

Where there are special circumstances, such as exceptional gradients, the compulsory use of wood paving, &c., tending to show that the car mileage does not fairly represent the wear and tear of the track, each such case is entitled to special consideration.

. . . . . .

5. In determining the cost of constructing new track, or of renewing any track, there shall be excluded all expenditure on concrete foundations, and on paving except such paving as lies between the rails and extends 18 inches beyond the rails on each side, and also the cost of the land on which the track may be laid and any other expenditure of a non-recurring nature.

Provided that where a tramway authority out of the revenue of the tramway undertaking is by Statute required as such authority to bear the cost of repair and renewal of a further portion of the road in addition to the portion between the rails and 18 inches beyond on each side, the cost of such repairs and renewals shall be allowed as a trading expense as and when incurred.

6. The cost of renewing concrete foundations shall be allowed as a trading expense as and when incurred, provided that if the renewed foundations are an improvement on the old the cost of such improvement shall be excluded.

7. Renewals of special track work at junctions and crossovers, so far as they do not represent improvements, shall be allowed as repairs as and when effected and shall be excluded from all claims for wear and tear.

8. Amounts received for old material whenever renewals are effected shall be credited against the cost of renewals, and if such old material is not disposed of

at the time or is used for other purposes, the estimated value shall be credited subject to adjustment, if necessary, as and when the old material is disposed of.

9. The cost of repairs shall be allowed as an expense as and when incurred.

. . . . . .

Cables

14. In addition to repairs, wear and tear is to be allowed at the rate of 3 per cent. per annum on the written-down value.*

Overhead Equipment, i.e. Trolley Wires and Connections

15. No wear and tear allowance is to be made; all expenditure on maintenance and renewals should be charged as working expenses, as and when incurred.

Cars and other Rolling Stock

16. Subject to the ensuing clause, expenditure on maintenance and renewals is to be treated as working expenses, and allowed in lieu of wear and tear.

Wear and tear, however, should be allowed in lieu of renewals where the circumstances justify such an allowance, provided that a strict account is kept of all renewals, and that, if such renewals are charged to revenue account, they shall be shown separately in such account and added back in computing the assessable profits.

The allowance in such cases is to be 7 per cent. per annum on the written-down value.

In any case, the annual expenditure on repairs is to be allowed as a deduction in computing the assessable profits.

General Plant and Machinery

17. All other plant and machinery, including standards, brackets, and workshop tools, but excluding loose implements, office furniture, and small articles, which require frequent renewal should be bulked together and wear and tear allowed thereon at the rate of 5 per cent. per annum on the written-down value, in addition to the cost of repairs.

WATER UNDERTAKINGS

No allowance is given, but all expenditure on repairs and renewals (excluding extensions and improvements) is allowed as a charge against revenue.

WROUGHT IRON MANUFACTURE

Plant and machinery generally . . . . . . 7½ per cent.

C. Rates for Particular Types of Plant, &c., Not Confined to Specific Industries

	Per cent.
ELECTRIC FURNACES	
All parts of the furnace, including transformers, switchgear, high and low tension cable connections, furnaces, tilting gear and regulators	12½
(No allowance is made in respect of foundations, buildings, cranes, buckets or any shop tools or equipment.)	
MOTOR OMNIBUSES	20
MOTOR PANTECHNICONS AND LORRIES	20
(This rate is not applicable to horse-drawn pantechnicons and lorries or to "lift" pantechnicons which are not a fixed part of a motor.)	
MOTOR LORRIES AND VANS, COMMERCIAL	20
STEAM LORRIES	15
RAILWAY WAGONS OWNED BY PRIVATE TRADERS	6¼
TAXI-CABS	20
TRACKLESS TROLLEY OMNIBUSES	15

* The value of cables is to include the cost of laying them, but is to exclude the cost of conduits (if any.)

INDEX

INDEX

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